S. Hrg. 99-129

REAUTHORIZATIONS FOR THE SECURITIES AND EXCHANGE COMMISSION, 1986–88

HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

S. 919

TO AMEND THE SECURITIES EXCHANGE ACT OF 1934 TO AUTHORIZE APPROPRIATIONS FOR THE SECURITIES AND EXCHANGE COMMISSION FOR FISCAL YEARS 1986-88

APRIL 17, 1985

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE
49-047 O WASHINGTON : 1985

S241-18

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REAUTHORIZATIONS FOR THE SECURITIES AND EXCHANGE COMMISSION, 1986-88

WEDNESDAY, APRIL 17, 1985

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Subcommittee on Securities,
Washington, DC.

The subcommittee met at 10:30 a.m., in room SD-538, Dirksen Senate Office Building; Senator D'Amato, (chairman of the subcommittee) presiding.

Present: Senators D'Amato, Cranston, Sasser, and Proxmire.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'Amato. Good morning. This is the Senate Banking Committee Subcommittee on Securities, and it is our pleasure to have Chairman John Shad testifying before us today.

I apologize for the 10:30 start. We had another important committee hearing which I had to attend. Our purpose for today's hearing is actually twofold—and I'm going to ask the chairman and others to bear with me because I do have a somewhat lengthy statement.

First, we are here to consider the Securities and Exchange Commission's request for the reauthorization for fiscal years 1986-88.

The Securities and Exchange Commission is the regulator of the securities industry and is responsible for ensuring that issuers provide adequate disclosure in order for investors to make informed investment decisions. The Commission also polices the markets to protect investors from fraud and other market abuses. The SEC keeps the capital markets operating smoothly and provides an efficient means for American businesses to raise the capital that is so vital to our economic system. And I would like to take this opportunity to commend Chairman Shad and the other Commissioners, and the staff at the SEC, for the excellent job the Commission has been doing.

The second purpose for today's hearing is to use it as a forum to explore some of the recent problems associated with the Government securities market—I might more aptly say, not so much as a forum, but as an opportunity at least for this Senator and any other that would like to express concerns in regard to this problem.

Today, the U.S. Treasury market debt outstanding is $1.7 trillion, of which $1.3 trillion represents marketable securities issued by the U.S. Treasury. The total debt was $500 billion 10 years ago.

The Treasury currently sells all of its marketable securities in competitive auctions. Dealers in U.S. Treasury securities are the primary purchasers and they in turn distribute the securities to their customers. It is estimated that there are approximately 300 dealers in the Government securities market, with most of the trading actually occurring among a nucleus of some 36 primary reporting dealers.

The U.S. Government securities market remains virtually unregulated today. And I say unregulated today with a little bit of emphasis. The Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisors Act of 1940 all exempted Government securities from the requirements, with the exception of the antifraud provision of the 1934 act.

Through the years, the lack of regulation and examination has hinged on the logic that deep pockets of the Federal Government left no question about the credit risk of the issuer. This nonregulation has helped make the market the most liquid and most efficient in the world.

Other than antifraud provisions and the fact that the SEC regulates some of the primary dealers because they are engaged in other types of securities trading, all other oversight is informal. To qualify as a primary dealer, the Federal Reserve Bank of New York requires that a firm have adequate capital and capable management, make markets and have a long-term commitment to the underwriting and distribution of Treasury securities. These firms must also submit to annual audits.

Recently, the New York Federal Reserve Bank proposed voluntary capital adequacy standards for U.S. Government securities dealers not covered by other forms of Federal supervision. They further urged that all participants in the market, including dealers, clearing banks, and investors, ask dealers not subject to official oversight for a letter certifying that they would adhere to a recognized capital standard.

Again, I must reiterate that this is all informal since there is no formal control over dealers that trade only in U.S. Government securities. This highly efficient and highly liquid Government securities market has not been without various market disturbances. The frequency of these disruptions has been increasing. The modern history of the failures reaches back some 10 years with the bankruptcy of Financial Corp. of Kansas City. This business failure, with losses of between $15–$24 million called attention for the first time to the risks involved in some of the complex repurchasing and trading transactions that were evolving in this market.

Financial Corp. of Kansas fell victim to interest rate suings and having insufficient working capital to sustain its operations. The losers were large, respectable institutions who found the market value of their collateral less than the amounts of the loans to financial corporations.

At approximately the same time period, we had the bankruptcy of Winters & Co., that was found in similar straights, but as a result of forward trading in Ginnie Mae's. When Winters & Co. closed in 1977, it was being investigated by the Federal Reserve and the National Association of Securities Dealers and was charged with fraud by the SEC. Following these two failures, most people felt that money market participants would implement new credit policy controls or shore up existing controls. However, having to rely on informal mechanisms, this did not occur.

On May 17, 1982, Drysdale Government Securities, a dealer which began operations only 3 months earlier, found itself closing its doors when it defaulted on $160 million in interest payments due on securities it had borrowed. How did the market allow a firm after only 3 months of operations and with initial capital of only $20 million to amass losses of this magnitude?

To state it as succinctly as possible, the customers did not properly value the collateral and were not sensitive to the magnitude of the exposure of Drysdale.

Drysdale had to borrow securities with high coupon rates on which a large amount of interest had accrued. The market practice was to ignore the value of accrued interest on pricing transactions involving the borrowing of securities.

Drysdale used that money to fund the speculation in the market. It continued to be hammered by heavy losses, which created a problem. Normally, when the interest payments on the bonds that Drysdale borrowed was actually paid by the Treasury, the firm would have to pass the interest along to whomever it borrowed the bond from in the first place.

But, Drysdale had, in effect, already used and lost the money.

Following close on the heels of Drysdale was the August 1982 bankruptcy of Lombard-Wall, Inc. Again, what forced Lombard-Wall into bankruptcy court was its maintenance of the much larger arbitrage positions than its capital would support. It closed with unsecured debts of $45 million to the Chase Manhattan Bank and $55 million to the New York State Dormitory Authority. I think that probably would have been the opportune time for us really to pause and say something is amiss—$55 million to the State dormitory authority alone. When we saw financial institutions in our States investing in this area, the situation should have been reviewed.

During 1984, two bankruptcies occurred. The new twist with these failures was that a large number of municipalities participated in the loss. Of course, it wasn't a totally new twist, since the State dormitory authority was an agency. RTD Securities closed leaving seven New York school districts and other creditors with losses of $7 million.

Lion Capital Group went bankrupt with 41 municipalities, including 31 school districts standing to lose $40 million in Government securities that were supposed to have been held in safekeeping by Lion.

Now, in 1985, here we go again. On March 4 of this year, ESM Government Securities, Inc., was forced into receivership by the SEC. What was reported as an obscure Florida Government securities dealer has left customers with losses estimated at $300 million, the largest in market history. The misdealings of this so-called obscure Florida dealership severely damaged depositor confidence in Ohio and forced a State mandated closing of 71 nonfederally insured thrifts. Amid ESM Securities alleged fraudulent double pledging of securities and a public auditor that, by appearance, was hardly independent, was the recurring practice of customers, in this instance S&L's, of loaning money and not taking possession of the securities.

The question that will linger is how could ESM Securities have gotten by with what they were doing as long as they did?

Last week, Bevill, Bresler & Schulman Asset Management Corp., a New Jersey Government securities dealer, failed. Estimates of their losses have ranged from $190 to $233 million. And, once again, the big losers appear to be S&L's.

A deliberate and proper assessment of this market has been deferred for too long. What appears to be most symptomatic of the problem is the complete breakdown of communication in this market. ESM Securities, for example, was drawing troubled and cautious glances from several agencies. However, with no one Federal agency tagged with the sole responsibility, no one was keeping score, or more importantly, alerting the market customers to the probable and what should have been known as the pending disaster.

The SEC began an investigation in 1977 when it received complaints concerning high markups on securities transactions handled by ESM Securities. The investigation was effectively blocked by ESM.

Ohio bank examiners reviewed some of ESM's transactions with a thrift in that State in 1982. ESM was examined by Florida regulators in 1983, but its problems were not revealed. Finally, ESM was audited by Alexander Grant & Co., which is accused of giving unqualified opinions on false financial statements even when ESM was insolvent.

These past disturbances in the market have not gone without the attention of this committee and certain market practice changes to try to better ensure the safety of the dealers and customers. In May 1982, this subcommittee held hearings following the collapse of Drysdale Government Securities. The market practice at the time was to ignore the value of accrued interest in the pricing transactions involving the borrowing of securities.

Following the collapse of Drysdale and these hearings, the market reacted by including the value of accrued interest in pricing these transactions.

I should also state that I am mindful of the importance of the Government securities market as both a source for funding our growing national debt and as a mechanism for the Federal Reserve's implementation of monetary policy. Because of this, I am sensitive to the need to maintain a market that is both liquid and efficient. However, notwithstanding these needs, it is my opinion that additional regulation should be required in the Government securities market in order to preserve the market's integrity.

Over the last few weeks, I have waited for the dust to settle on the ESM situation before moving ahead with a legislative proposal. While the dust was settling on ESM, we discovered another costly set of initials from Livingston, NJ—BBS Government Securities.

My staff has met with representatives of both the regulators and the industry. All of these findings have led me to the conclusion that action is required.

In the first instance, we need to educate the public regarding taking possession of collateral and avoiding undue concentration of business with any one Government securities dealer. In addition, we need to encourage a greater communication amongst the regulators. Finally, we must require disclosure regarding the financial health of Government securities dealers as well as subjecting dealers to capital adequacy standards and oversight and review.

In the coming weeks, I will be introducing legislation intended to accomplish these goals. Based upon considerations of cost and efficiency, I feel that the most prudent course of action is to subject a now unregulated Government securities dealers to the oversight authority of a self-regulatory organization, in this case, an expanded municipal securities rulemaking board [EMSRB]. The EMSRB, which was created by the Securities Act Amendments of 1975, has proven to be an effective and efficient means of regulating the municipal securities market with a minimal amount of Federal intrusion into the market.

Based upon the experience in the municipal securities markets since 1975, I believe that the cost of extending federally supervised self-regulation to the Government securities market will be relatively modest, and most necessary. At the same time, direct benefits of deterring of uses in these markets should be substantial.

I hope to have legislation ready by May 2, the date of this subcommittee's next hearing on the Government securities market.

Mr. Chairman, I apprecite your tolerance during this somewhat lengthy introduction. But I believe there were a number of matters that should be put on the record. Also, I look forward to continuing to work with you and your staff in hopefully developing a legislative proposal that will again bring about better security oversight and not impair the market and its efficiency.

[Copy of proposed bill follows:]

II

99TH CONGRESS
1ST SESSION

S. 919

To amend the Securities Exchange Act of 1934 to authorize appropriations for the Securities and Exchange Commission for fiscal years 1986 through 1988.

IN THE SENATE OF THE UNITED STATES

APRIL 16 (legislative day, APRIL 15), 1985

Mr. D'AMATO (by request) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

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A BILL

To amend the Securities Exchange Act of 1934 to authorize appropriations for the Securities and Exchange Commission for fiscal years 1986 through 1988.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 35 of the Securities Exchange Act of 1934 (15 U.S.C. 78kk) is amended—

(1) in the first sentence thereof, by striking out "and" immediately after "1982,";

(2) by inserting immediately before the period at the end of the first sentence thereof the following: ", $113,647,000 for the fiscal year ending September 30, 1986, $116,023,000 for the fiscal year ending Septem-

ber 30, 1987, and $121,837,000 for the fiscal year ending September 30, 1988"; and

(3) in the last sentence thereof, by striking out "fiscal year 1983" and inserting in lieu thereof "fiscal year 1988".

○

Senator Cranston, any statement?

OPENING STATEMENT OF SENATOR CRANSTON

Senator **Cranston**. Yes. Thank you very much, Mr. Chairman.

I would also like to welcome you, Chairman Shad, here today to testify on the SEC request for reauthorization. The SEC is to be commended for the manner in which it has fulfilled its responsibilities over the years and during your tenure.

It has, through its oversight and enforcement, brought confidence to our capital markets. We have the most varied and vital capital markets in the world. The ever-expanding volume of trading activity and complexity of these markets are a constant challenge, I am sure, to the SEC as its primary regulator.

While the hearing today is specifically on SEC's budget, I would like to state that there is a growing concern as we in Congress witness the series of failures in the unregulated Government securities market, as Chairman D'Amato has just stated so clearly and strongly.

Senators Proxmire and Riegle are joining me in a bill I will introduce today to bring unregulated securities brokers and dealers under a self-regulatory structure under the auspices of the SEC.

There has been discussion among regulators and market participants as to what kind of regulation is needed in this area since the first large failure—Drysdale Securities, Inc.—in 1982.

We believe that it is now appropriate for those discussions to have a congressional focus so that a coordinated effort can be made to fully explore all the desirable alternatives and then to take appropriate remedial action legislatively.

I am pleased that Chairman D'Amato will also be introducing legislation soon in regard to this problem. I trust that we can join together in a bipartisan effort as we consider these proposals in the near future in this subcommittee, and if you would like to cosponsor my bill that I am going to introduce today, I probably will be ready to cosponsor yours, although I haven't seen the text of it.

Senator **D'Amato**. Let me say to my colleague, Senator Cranston, that there is no pride of authorship, and I know that that is the same for yourself and Senators Proxmire and Riegle. I think there is a mutual desire in a bipartisan manner to see to it that the abuses that have taken place are curbed, that we have the kind of oversight that will curtail this.

And we certainly don't want to damage the liquidity of this marketplace, but we have got to see to it that there are adequate regulations to protect the public.

Indeed, we have seen the most horrendous examples of what has taken place, and there is no reason to believe they will not occur in the future unless we undertake this action.

I would be most interested in reviewing the Senator's legislation, and I would not be a bit surprised if I might not cosponsor your initiatives. Of course introducing legislation is in no way saying that this is what we are bound to, but rather this is a beginning to the process. That is why these hearings will be held on May 2—to make the public focus and have the various groups and regulatory agencies testify with respect to the effects of that legislation.

So, Alan, I am delighted that we are joined together in trying to accomplish the principles of providing better market safety for our people.

Senator **CRANSTON**. Great, Al. I look forward to working with you on this, as we have worked together on many other programs.

Senator D'**AMATO**. Chairman Shad, thank you for your patience.

STATEMENT OF HON. JOHN S.R. SHAD, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. **SHAD**. Thank you very much, sir, Chairman D'Amato and Senator Cranston and the other members of the subcommittee.

First, it is requested the 1986-88 budget authorization request, previously submitted to the subcommittee, be included in the record.

Senator D'**AMATO**. So ordered.

AUTHORIZATION REQUEST

Mr. **SHAD**. I am going to cover the authorization request, the Commission's fiscal 1984 results and ongoing activities, and, as requested, discuss briefly recent developments in the Government securities market.

Appropriation authorizations for fiscal years 1986-88 are requested in the amounts of $113.6, $116, and $121.8 million, respectively, in order to implement prospective legislation, to cover rising costs, and upgrading the Commission's mainframe computer.

Prospective legislation includes bills which would permit banks to underwrite municipal revenue bonds and mortgage-backed securities and sponsor and distribute mutual funds through separate corporate affiliates, subject to the SEC's regulation.

Senator D'**AMATO**. Where did you get that? Where did you get the idea that is going to happen?

This gives me an opportunity to speak on one of my pet peeves. I just cannot believe—given what we are repeatedly seeing—that we are really going to allow banks to undertake this risky business of underwriting securities, and getting into mutual funds and letting them underwrite insurance as well. I think it has a long way to go. You know something, if somebody wants to go out there and undertake a risky business activity, then let them do it.

But I don't think the SEC and the Federal Treasury should be underwriting their adventure in the business area, and that is my own point of view.

Mr. **SHAD**. Well, this is only a small piece of it. But actually 1988 is a long way off, and there are these bills in the hopper, and in fact we haven't anticipated what could come out of the proposed legislation that each of you discussed this morning.

Senator D'**AMATO**. I mean, I realize that bill passed the Senate, I guess 93 to 3. [Laughter.]

And I want you to know I waited till Senator Garn was as far away from town as he possibly could be before I said this. [Laughter.]

Mr. **SHAD**. Another area of prospective legislation involves the recommendations of the Vice President's task group on regulation of financial services. Those recommendations would consolidate within the SEC the administration and enforcement of the securities registration and reporting requirements for publicly owned banks and thrifts.

Based on Federal pay increases projected by OMB, personnel expenses for the Commission's current staff will also rise significantly over the next 3 years, as will other expenses, due to inflation and the need to upgrade the SEC's mainframe computer.

A 3-year authorization is needed to define the limits within which the Commission can implement its electronic disclosure system, other productivity improvements and ongoing programs.

The following are brief highlights of the Commission's fiscal 1984 results:

Investor protection and corporations' financing flexibility were increased, and unnecessary paperwork and other expenses ultimately borne by investors were reduced.

Through automation, paperwork reduction, and other staff initiatives, record results or the highest levels in years were achieved in the volume and efficacy of enforcement actions, investment company and investment adviser inspections, broker-dealer examinations, and reports processed, self-regulatory organization inspections, full disclosure filings processed, and appellate and other cases opened.

Since fiscal 1981, the annual volume of these and other Commission activities have been increased by 19 to 78 percent, with 5 percent less personnel, and accounting firm peer reviews under SEC oversight has been increased more than 100 percent.

EDGAR SYSTEM

The pilot high speed electronic disclosure system, known as Edgar, was commenced on schedule in September. By the 5th of this month, 872 documents have been filed electronically over telephone lines, on diskettes and magnetic tapes.

The 150 participants range from Exxon, General Motors, IBM, and other major industrial utility and financial corporations to small limited partnerships. GMAC, one of the most frequent Edgar filers, has indicated that the electronic system has enabled them to respond more rapidly to changing market conditions.

Edgar is intended to improve and accelerate dramatically the filing, processing, dissemination, and analysis of corporate information; the manner in which many investment decisions are made and executed; the efficiency of the securities markets; and the Commission's ability to discharge its congressional mandate to protect investors and maintain fair and orderly markets.

As corporate reports are electronically filed with the SEC, investors, security analysts, and others will have instant access to them on home and business computer screens. The filings will also be simultaneously transmitted to the securities exchanges and other self-regulatory organizations and to all the State security commissions.

California, Georgia, and Wisconsin are already receiving Edgar filings.

The Commission is proceeding with a view to phasing all SEC issuers into the Edgar system, beginning next year and completing the project by 1988.

Also, last year the Commission brought a record 299 enforcement actions; 43 involved broker-dealers and other regulated entities; 28 percent, registration and issuer frauds; 17 percent, financial disclosure and accountants; and 12 percent insider trading, market manipulation, and changes in corporate control.

The Insider Trading Sanctions Act, which was introduced by Chairman D'Amato, was signed by the President in August. Previously, most inside traders have been enjoined and required to disgorge only their profits, which has not been much of a deterrent. Now, they will be subject to civil fines up to three times their profits.

The act also increased criminal fines for securities laws violations from the $10,000 established 50 years ago to $100,000 per count.

The revised shelf registration rule adopted last November has increased the largest and most creditworthy corporations' financial flexibility and reduced their expenses for the benefit of their shareholders by hundreds of millions of dollars per annum without compromising full disclosures.

These large savings are principally due to keener competition among underwriters and among the institutions which purchase the bulk of such issues, whether under shelf or conventional offerings.

Simplification and improvement of proxy statements and prospectuses during the past year have reduced their cost and increased their utility to investors.

As a result of legislation introduced by Chairman D'Amato, which implemented the SEC/CFTC accord, new options and futures have been authorized which permit investors and corporations to hedge stock market, foreign currency and other risks at a fraction of the cost of prior means of hedging or reducing such risks.

At the Commission's initiative, the exchanges are installing electronic intermarket stock and options surveillance systems and transaction audit trails for the quick detection of inside traders and market manipulators. Audit trails also reduce transaction reconciliation costs, which are ultimately borne by investors.

SAVINGS OVER $35 MILLION

In each of the last 2 fiscal years, registration, transfer, and other fees collected by the Commission exceeded expenses. This has only happened once before. The savings in the last 2 years have amounted to over $35 million. Fiscal 1985 fees are also expected to exceed the Commission's expenses.

With the encouragement of Chairman D'Amato, rules adopted by the Commission last year will telescope the time and expense of corporations' communications with their shareholders by requiring broker-dealers, commencing next January, to provide corporations with the identity of those shareholders who do not object.

Chairman D'Amato has also introduced legislation which would permit the Commission to implement similar rules for banks. Favorable congressional action on this legislation during the current session is strongly recommended.

The recommendations of Vice President Bush's task group on regulation of financial services include consolidation within the Securities and Exchange Commission of the securities registration and reporting requirements for all publicly owned banks and thrifts. This will result in more uniform disclosure and enforcement requirements, at lower costs. Favorable action on the task group's recommendations is also recommended.

Last year, the Commission recommended that the Investment Company Act be amended to make it easier for the Commission to permit foreign investment companies to register and sell shares in the United States, when the Commission finds this to be consistent with the purposes of the act and the protection of investors. Congressional consideration of this proposal is also requested.

The Securities Investor Protection Corp. [SIPC] has proposed legislation to amend the Securities Investor Protection Act of 1970 in order to preserve the jurisdiction of bankruptcy judges over SIPC liquidations of insolvent broker-dealers and to make other changes in SIPC liquidation procedures. These objectives deserve congressional support.

In March of this year, the Commission submitted to Congress an updated version of the Securities Law Technical Amendments Act, which would make various technical changes and conforming amendments in the Federal securities laws. This proposal has been introduced as H.R. 1604. Congressional consideration of this legislation is also requested.

Fiscal 1984 was the 50th anniversary of the SEC. The year's record results are attributed to the Commissioners and the fine men and women who serve throughout the agency. In addition to ongoing programs, the future offers the prospect of major improvements in the regulatory structures of the financial service industries and the exciting potential of high-speed electronic filing, processing, dissemination, and analysis of corporate information.

The subcommittee has also requested a discussion of recent developments in the Government securities market. Chairman D'Amato just placed the entire issue in perspective historically, and I am going to deal only with the most current matters that are now before us. But I would like to characterize the market briefly.

The annual dollar volume of trading in U.S. Government and agency obligations is over 15 times that of all U.S. securities exchanges and over-the-counter markets. It is by far the world's largest and most efficient securities market.

This highly liquid, keenly competitive market is of paramount importance to the effective, low-cost financing of the national debt as well as administration of the Nation's fiscal and monetary policies.

If regulations were to increase interest rates on Treasury securities by one-tenth of 1 percent, it would increase Federal interest costs by $2 billion per annum. Conversely, highly publicized failures of small Government securities firms have had international repercussions.

As Chairman D'Amato mentioned, there are 36 primary Government bond dealers that report to the Federal Reserve Board on a daily, monthly, and annual basis, and an unknown number of secondary firms, 27 of which report on a monthly basis. And that would include ESM and BBS, the two firms that recently are in trouble.

These firms primarily deal with institutions rather than individuals. The Fed is expected to adopt shortly voluntary capital adequacy guidelines for dealers not otherwise subject to Federal regulation.

Neither the Fed nor the SEC has specific statutory authority over those firms that deal exclusively in Government securities. Nevertheless, all but a small portion of such transactions are handled by primary dealers monitored by the Fed; banks subject to the jurisdiction of the Fed, the Comptroller of the Currency, and the FDIC; or registered broker-dealers subject to inspection and regulation by the SEC and various self-regulatory organizations.

The SEC also has the authority to bring actions against these firms—all of the foregoing—and anyone else that engages in fraudulent securities activities.

Also, virtually all financial institutions which purchase Government securities are subject to regulation by State or Federal agencies or are governed by State or municipal statutes.

Over the past 7 years, the widely publicized failures of seven small Government securities dealers, including within the past month ESM Government Securities, Inc. and Bevill, Bresler & Schulman Management Corp., referred to as BBS, have had repercussions throughout the financial markets.

The SEC estimates that over $500 million of losses, before taxes, insurance, and civil suit recoveries, if any, have been sustained by the firms and institutions that dealt with ESM and BBS. Such losses have been attributed principally to: Fraudulent concealment of ESM's and BBS's financial conditions; their use of the same collateral for multiple transactions; and, in the case of ESM, over $200 million of its $300 million of losses attributed to transactions with two thrift institutions that were under the control of the same individual.

REVIEW OF THE REGULATORY PROCESS

On March 21, the Commission indicated at hearings that it would review the regulatory structure of the Government securities markets in consultation with the Fed and the Treasury and report its views to Congress within 90 days. That is by June 21.

This effort is underway. Senior members of the Commission staff and I have met with Chairman Volcker of the Federal Reserve Board, Secretary of the Treasury James Baker, and their staffs.

The Commission authorized publication of a release yesterday, seeking comments on the Government and bond market and dealers. Questions posed include the following:

How can such losses be reduced or prevented on a cost-effective basis?

A threshold question—I think this is a very important question—is the reaction of the marketplace, investors, dealers, depositors, the accounting profession, the regulators to the widely publicized ESM and BBS failures.

Are those who invest in Government securities shifting from small to large dealers, as has been reported in the press?

It was also reported this morning in the Wall Street Journal that a task force of the AICPA is discussing today more stringent standards and procedures to confirm the collateral behind Government securities transactions.

The Journal also reported the SEC is examining the records of many Government securities dealers. The Commission neither confirms nor denies such reports as a general policy.

In any case, if greater regulation is necessary, which of the following or other alternatives would reduce or eliminate future mistakes and deceptions at the least cost?

Should dealers be required to deliver through the Fed wire or other book entry systems Government securities that are transferred or pledged under repurchase agreements?

Should the Fed's proposed voluntary capital adequacy guidelines for Government dealers be made mandatory?

Should the guidelines be expanded to include voluntary registration and segregation of customer positions subject to audit and inspection by the Fed or by the SEC?

Should a self-regulatory organization be created under the aegis of the Fed or the SEC, or should the authority of the Municipal Securities Rulemaking Board, under the SEC's oversight, be expanded to include Government securities markets and dealers?

What responsibilities and authorities should such a regulatory body have? Should its authority be limited to imposing financial and operational requirements, or should it include regulation of the business practices of Government securities dealers?

These are but a few of the major issues and questions that have been posed in the Commission's release that was approved for publication yesterday. It would be premature to speculate on the various possibilities before the Commission, in consultation with the Fed and the Treasury, as it is committed to do, has obtained and analyzed the best available facts.

The Commission will attempt to weigh the costs and the benefits of the various alternatives and will promptly submit its conclusions to Congress.

Thank you very much, and I appreciate your tolerance. That was a long statement.

[The complete prepared statement follows:]

STATEMENT OF JOHN S.R. SHAD,
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION,
TO THE SUBCOMMITTEE ON SECURITIES OF THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

CONCERNING

SEC REAUTHORIZATION, OVERSIGHT AND
GOVERNMENT SECURITIES

April 17, 1985

Chairman D'Amato and Members of the Subcommittee:

This statement discusses the Securities and Exchange Commission's 1986-88 reauthorization request, fiscal 1984 results and ongoing activities and issues related to the government securities market.

It is requested that the separate statement of the Commission's 1986-88 authorization request be included in the record.

A three-year authorization is requested for appropriations in the amounts of $113.6 million for fiscal 1986, $116.0 million for fiscal 1987, and $121.8 million for fiscal 1988.

I. OVERVIEW OF FISCAL 1984 RESULTS AND ONGOING EFFORTS

The Commission's Fiftieth Annual Report, transmitted to Congress in January, provides a detailed review of fiscal 1984 activities. The following briefly highlights such results and ongoing activities.

Investor protections and corporations' financing flexibility were increased, and unnecessary paperwork and other expenses, ultimately borne by investors, were reduced.

Through automation, paperwork reduction and other staff initiatives, record results (or the highest levels in years) were achieved in the volume and efficacy of enforcement actions, investment company and adviser inspections, broker-dealer oversight examinations and reports processed, self-regulatory organization inspections, full disclosure filings processed, and appellate and other cases opened.

Since fiscal 1981, the annual volume of these activities has been increased by 19% to 78%, with 5% less personnel. Also, the 1981-84 average annual rate of accounting firm peer reviews, under SEC oversight, has been increased more than 100% over the 1978-80 rate, from an average annual rate of 65 during 1978-80 to an average annual rate of 139 during 1981-84.

Summary of Activities
Securities and Exchange Commission:

SEC Fiscal Years Ended Sept. 30th	1981	1982	1983	1984	1981-4 Change
Investment Co. & Adviser Inspections	748	1,065	1,085	1,335*	+78%
SRO** Inspections	12	19	18	20*	+67%
Appellate and Other Cases	102	115	143	167*	+64%
Enforcement Actions Brought	191	254	261	299*	+57%
Broker-Dealer Oversight Examinations	278	249	324	389*	+40%
Broker-Dealer Reports Processed	6,106	6,599	7,067	8,290*	+36%
Full Disclosure Filings Processed	56,919	63,423	65,550	67,466*	+19%
Staff-Years	1,982	1,881	1,921	1,885	- 5%
Fees as a Percent of Budget	81%	94%	110%	129%*	

* A record or the highest level in years.
** Self-Regulatory Organization.

A. Edgar

The pilot high-speed electronic disclosure system ("Edgar") was commenced on schedule in September. It is intended to improve and accelerate dramatically the filing, processing, dissemination and analysis of corporate information; the manner in which many investment decisions are made and executed; the efficiency of the securities markets; and the Commission's ability to discharge its Congressional mandate to protect investors and maintain fair and orderly markets.

As corporate information is filed with the Commission, Edgar is intended to afford investors, security analysts and others, instant access to it on home and office computer screens. Edgar will thereby accelerate corporations' access to the capital markets and the dissemination of their information to the investing public. It will also save time and errors by eliminating the frequent need to transfer data manually from one format to another; and will enable the Commission's staff to process filings more efficiently.

The pilot system accepted its first electronic filing on September 24, 1984. Through April 5, 1985, 782 filings have been received. The 150 participants range from General Motors, Exxon, IBM and other major industrial, utility and financial corporations to small limited partnerships. The filings include annual and interim reports, proxy and registration statements, post-effective amendments and other forms. They are filed directly over telephone lines, on diskettes and magnetic tapes. Public access to the pilot filings is available through terminals in the Commission's Washington, Chicago and New York Public Reference Rooms. Computer generated microfiche is produced overnight, which is two weeks faster than for paper filings.

Staff reviews are also faster because information is available instantly at work stations, rather than through manual delivery of microfiche or paper copies; and the staff has immediate access to external data-bases, which expedites research of complex legal, accounting and other matters.

The benefits to issuers are that their filings are received, processed and disseminated faster. General Motors Acceptance Corporation has indicated that Edgar has enabled it to respond rapidly to changing market conditions and get to the market faster.

Electronic mail and fee payment capabilities have been added; and the Commission is experimenting with image processing and encryption devices. Edgar filings will also be simultaneously transmitted to all the state securities commissions, the securities exchanges and the National Association of Securities Dealers, Inc. California, Georgia and Wisconsin are already receiving Edgar filings.

Additional pilot projects underway within the Commission, include the use of computer work stations by:

- the Investment Management Division for investment company and public utility filings, and to review investment company and adviser inspection reports;
- the Enforcement Division to analyze trading patterns, mark-ups and mark-downs; and
- the Chicago Regional Office to support enforcement investigations and process small issuer filings.

The Commission is proceeding with a view to phasing all SEC issuers into a fully integrated system beginning in 1986 and ending in 1988.

Telecommunication technology has already had a dramatic impact on the domestic and international securities markets. It has permitted global trading in world class securities; high-speed electronic execution and confirmation of the record volumes of securities transactions and financings; and hundred million dollar savings, through the use of electronic book-entry delivery systems. Edgar is the next step. It has the potential to improve the manner in which investment decisions are made and executed, and the efficiency and fairness of the securities markets.

B. Enforcement

The 299 enforcement actions initiated in fiscal 1984 included 128 cases alleging misconduct by broker-dealers, investment advisers and other regulated entities; 48 cases alleging failure to register securities offerings; 36 cases alleging issuer fraud and reporting violations; 33 cases alleging financial disclosure violations by issuers and their employees; 18 cases alleging misconduct by accounting firms, their partners and employees; 13 cases alleging insider trading; 12 cases alleging market manipulation; and 11 cases arising out of changes in corporate control.

C. Insider Trading Sanctions Act

This Act was introduced by Chairman D'Amato and signed by the President in August. Most inside traders have been enjoined from future violations, but have only been compelled to disgorge their profits, which has not been much of a deterrent. Now they will be subject to civil fines, up to three times their profits. Criminal fines for violations of the securities laws were also increased -- from the $10,000 established 50 years ago, to $100,000 per count.

D. Revised Shelf Registration Rule

The revised shelf registration rule, adopted in November, 1984, has increased the largest and most creditworthy corporations' financing flexibility and reduced their expenses, for the benefit of their shareholders, by hundreds of millions of dollars per annum, without compromising full disclosures. These large savings are principally due to keener competition among underwriters, and among institutions which purchase the bulk of such issues, whether under shelf or conventional offerings. The Commission is continuing to monitor the effects of the rule and will take appropriate action, if warranted.

E. Proxies and Mutual Fund Prospectuses

Simplification and improvement of these documents have reduced their cost and increased their utility to investors.

F. New Options

As a result of legislation introduced by Chairman D'Amato, which implemented the SEC/CFTC Accord, new options and futures have been authorized which permit investors and corporations to hedge stock market, foreign currency and other risks at a fraction of the cost of prior means of hedging or reducing such risks.

G. Intermarket Surveillance

At the Commission's initiative, the exchanges are installing electronic intermarket stock and options surveillance systems and transaction audit trails for the quick detection of inside traders and market manipulators. Audit trails also reduce transaction reconciliation costs, ultimately borne by investors.

H. Budget

Registration, transfer and other fees collected by the Commission exceeded its budget by 29%. In each of the past two fiscal years such fees have exceeded the Commission's budget. This has only happened once before. The savings in the last two years amount to over $35 million.

I. Shareholder Communications

With the encouragement of Chairman D'Amato, the Commission in 1984 adopted rules that will telescope the time and expense of corporations' communication with their shareholders, by requiring brokers (commencing next January) to provide corporations with the identity of those shareholders, who do not object. Legislation which would permit the Commission to implement similar rules for the banks has been introduced in the House. Favorable Congressional action on this legislation during the current session is strongly recommended.

J. Bush Task Group

The recommendations of Vice President Bush's Task Group on Regulation of Financial Services include consolidation within the SEC of the securities laws filings of all publicly owned banks and thrifts and other major legislative initiatives for the benefit of investors and depositors. Favorable Congressional action on the Task Group's recommendations is also recommended.

K. Foreign Investment Companies

In January of 1984 the Commission recommended that the Investment Company Act of 1940 be amended to make it easier for the Commission to permit an operating foreign investment company to register under the Act and sell its shares in the United

States when the Commission finds this to be consistent with the purposes of the Act and the protection of investors. Congressional consideration of this proposal is respectfully requested.

L. SIPA Amendments

The Securities Investor Protection Corporation ("SIPC") has proposed legislation to amend the Securities Investor Protection Act of 1970 ("SIPA") in order to preserve the jurisdiction of bankruptcy judges over SIPC liquidations of insolvent broker-dealers and to make other changes in SIPC liquidation procedures. These objectives deserve Congressional support.

M. Technical Amendments

In 1983 the Commission proposed the Securities Law Technical Amendments Act, which would have made various technical changes and conforming amendments in the federal securities laws. In March of this year, the Commission submitted an updated version of the bill to Congress, described in more detail below, and it has been introduced as H.R. 1604. Congressional consideration of this legislation is also requested.

N. Conclusion

The 50th Anniversary year results are a tribute to the Commissioners and the fine men and women who serve throughout the agency. In addition to ongoing programs, the future offers the prospect of major improvements in the regulatory structures of the financial service industries and the exciting potential of high speed electronic dissemination and analysis of corporate information.

II. DISCUSSION

A. Budget Authorization for Fiscal Years 1986-1988

The Commission seeks authorization for appropriations in the amounts of $113.6 million in fiscal 1986, $116 million in fiscal 1987, and $121.8 million in fiscal 1988, in order to implement prospective legislation, cover rising costs, and upgrade the Commission's mainframe computer.

The Glass-Steagall Act amendments and the recommendations of the Bush Task Group on Regulation of Financial Services would permit banks to underwrite municipal revenue bonds and mortgage-backed securities and to sponsor and distribute mutual funds, and would require publicly-owned banks and thrifts to file with the SEC. These measures would significantly increase the number of broker-dealers and investment companies subject to SEC supervision, and the volume of filings with the SEC. Additional staff will be required to review and comment on such filings and requests for interpretations, to conduct cause and oversight examinations, and to enforce the securities laws.

Personnel expenses for the Commission's current staff will rise appreciably due to federal pay increases projected by OMB for fiscal 1987 and 1988. Additional costs would be generated by mandatory merit payouts, within-grade increases, and the need to annualize the salaries of new staff. Non-personnel expenses will rise due to inflation and the need to upgrade the Commission's mainframe computer.

A three-year authorization is needed to strengthen the Commission's ability to fulfill its mandate. Ensuring investor protections, facilitating capital formation, and accommodating market changes are goals requiring long-range planning and multi-year commitments. Projects designed to achieve these goals, such as the electronic disclosure system and the productivity improvement programs, are multi-year efforts. A three-year authorization is needed to define the limits within which the Commission can proceed with these programs and its ongoing activities.

B. Legislative Proposals

1. Bush Task Group Recommendations

During the past four years, in Congressional testimony, speeches and discussions with members of the Cabinet and the chairmen of the Senate and House committees concerned, the Commission has recommended that financial services be regulated by functional activities, rather than by outmoded industry classification; that overlapping, duplicative, and conflicting regulatory activities be consolidated; that excessive regulations within and between agencies be eliminated;

and that a one-year task group be formed to refine these concepts and assist Congress in their implementation.

The Bush Task Group has made such recommendations. The main proposals affecting the Commission would repeal the exemptions in the Securities Act of 1933 for registration of securities issued by banks and savings and loan associations and would consolidate, within the Commission, administration of the periodic reporting, proxy solicitation and short-swing profits provisions of the Securities Exchange Act of 1934 as they relate to such institutions. The Federal Reserve Board, the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board presently administer such regulations for different categories of banks and thrift institutions. The SEC administers such regulations for all other publicly-owned corporations, as well as for bank and thrift holding companies. Consolidation within the SEC will permit more uniform and efficient administration and enforcement of these and other requirements at lower cost.

The Task Group recommendations also include amendments of the Securities Act to broaden the authority of the Commission to grant exemptions from registration deemed to be in the public interest; exempt registration of securities issued in connection with conversions of banks into holding companies, where there will be no material change in the security holders' rights and interests; repeal the Public Utility Holding

Company Act; and implement other measures intended to simplify, improve and increase the cost-effectiveness of the regulation of the securities, banking and thrift industries.

2. Shareholder Communications

Last year the Commission proposed, and Chairman D'Amato introduced, legislation that would amend Section 14(b) of the Exchange Act to authorize the Commission to regulate the dissemination of proxy materials by banks, associations and other entities in the same fashion as the Commission regulates the dissemination of proxy materials by broker-dealers. It was also introduced in the House and approved by the Committee on Energy and Commerce. The Commission continues to support this legislation and requests that Congress act on it during this Session.

This legislation would permit the Commission to adopt regulations, similar to those that will become effective January 1, 1986 for broker-dealers, to require that banks provide corporations with the identity of their shareholders who do not object.

3. Foreign Investment Companies

Section 7(d) of the Investment Company Act currently prohibits a foreign investment company from offering its shares in the United States unless the Commission issues an order permitting it to register under the Act and to make such an offering. Section 7(d) requires that the Commission make certain findings before issuing such an order that cannot be made in the case of most foreign investment companies. As a result, foreign companies are denied access to American capital markets, and American investors are denied the opportunity to make such investments.

In February of 1984 the Commission recommended that the Act be amended to make it easier for the Commission to permit an operating foreign investment company to register under the Act and sell its shares in the United States when the Commission finds this to be consistent with the purposes of the Act and the protection of investors. Congressional consideration of this proposal is respectfully requested.

4. SIPA Amendments

The Securities Investor Protection Corporation has proposed legislation, which has been introduced in the House, to amend the Securities Investor Protection Act in order to preserve the jurisdiction of bankruptcy judges over SIPC liquidations of insolvent broker-dealers. The Bankruptcy Amendments and Federal Judgeship Act of 1984 permits a party to seek to have a particular proceeding relating to customer claims decided by a district court judge rather than by a bankruptcy judge, resulting in possible bifurcation of SIPA proceedings. The proposed SIPA amendments are intended to assure that bankruptcy judges generally would decide these customer claims.

In addition, the amendments would give SIPC an automatic right to participate in related state court proceedings. This is important because the bankruptcy amendments encourage the abstention of federal district courts on state law claims or causes of action related to bankruptcy cases. Finally, the proposed amendments would change existing law relating to the manner in which aggrieved customers can obtain judicial review of determinations in direct payment proceedings under SIPA. The amendments would permit only district court judges, rather than bankruptcy judges, to review these determinations.

These objectives deserve Congressional support.

5. Technical Amendments

In 1983 the Commission proposed the Securities Law Technical Amendments Act to make technical, clarifying, and conforming amendments to the securities laws. The bill, introduced as H.R. 4574 of the 98th Congress, was prepared by Commission staff in response to a request by House Subcommittee Chairman Wirth for legislative proposals to eliminate anomalous and outmoded provisions of the securities laws.

The Commission last month proposed a similar technical amendments bill, the Securities Law Technical Amendments Act of 1985, introduced in the House as H.R. 1604. The great majority of the proposals in the new bill are technical corrections eliminating typographical errors and obsolete and ineffective provisions. For the most part, the provisions are identical to those found in H.R. 4574. The bill's more substantive provisions include the following:

First, Section 105, which was contained in H.R. 4574, would eliminate a possible form of discrimination against savings and loans as compared to banks, by deleting the condition applicable to savings and loan associations that, for their securities to be exempt from registration, they not change certain entry fees.

Second, Section 209, which was also included in H.R. 4574, would give the Commission authority to decline to accept payment of fees in cash, thereby reducing security problems and eliminating the need for separate accounting records.

Third, Sections 219(1) and (2), 509, and 602(1), (2), and (3), which are new, would permit the Commission to impose administrative sanctions on persons already within its jurisdiction for misconduct relating to transfer agent activities. These amendments also would substantially conform the disqualification and sanction provisions in the Investment Company and Investment Advisers Acts to those in the Exchange Act. This would permit the Commission to impose administrative sanctions for misconduct arising out of activities in the municipal securities and commodities markets on investment advisers and persons associated with investment advisers, as well as on the management of investment companies. In a similar vein, Section 221 would conform the sanctioning provisions applicable to municipal securities professionals to those applicable to other securities professionals by authorizing the Commmission to "place limitations" on the activities of municipal securities professionals.

Fourth, Section 223, which was included in H.R. 4574, provides for self-regulatory organization access to the complete results of fingerprint identification processing.

Fifth, Section 224, which is new, would expand authority of the Commission and the federal bank regulatory agencies that regulate transfer agents in three primary ways. First, the agencies would be authorized to bring administrative proceedings against professionals associated with the transfer agents they regulate. Second, it would expand the grounds for sanctioning transfer agents in administrative proceedings to include convictions and injunctions relating to financial services industry activities and violations of the securities laws in addition to Section 17 and 17A of the Exchange Act. At present, the grounds for imposing administrative sanctions on transfer agents include only violations of, or inability to comply with, Sections 17 and 17A and the rules thereunder, which relate to recordkeeping and clearing and settling securities transactions. Third, Section 224 would allow the agencies to bring administrative proceedings against a transfer agent for acts of professionals associated with the transfer agent.

Congressional consideration of this legislation is requested.

C. The Government Securities Market

Because of the widely publicized failures in recent weeks of two government securities dealers -- E.S.M. Government Securities Inc. ("ESM"), and Bevill, Bresler & Schulman Asset Management Corp. ("BBS") -- the Subcommittee requested that issues concerning the government securities market be addressed in this statement.

The Market: The annual dollar volume of trading in U.S. government and agency obligations is over 15 times that of all U.S. securities exchanges and over-the-counter markets. It is by far the world's largest and most efficient securities market. This highly liquid, keenly competitive market is of paramount importance to the effective, low-cost financing of the national debt as well as administration of the nation's fiscal and monetary policies. In addition, the government securities markets are important to the other nations that use U.S. dollars and government securities for their reserves and as a medium of international exchange; as well as to commercial enterprise throughout the free world. If regulations were to increase interest rates on Treasury securities by 1/10th of 1%, it would increase federal interest costs by $2 billion per annum. Conversely, highly publicized failures of small government securities dealers have had international repercussions.

The Regulatory Structure: There are 36 primary government bond dealers that report to the Federal Reserve Board ("Fed") on a daily, monthly, and annual basis; and an unknown number of secondary dealers, 27 of which report on a monthly basis. These firms primarily deal with institutions, as opposed to individuals. The Fed has indicated that it intends to adopt voluntary capital adequacy guidelines for dealers not otherwise subject to federal regulation.

Neither the Fed nor the SEC has specific statutory authority over those firms that deal exclusively in government securities. Nevertheless, all but a tiny fraction of such transactions are handled by primary dealers, monitored by the Fed; banks subject to the jurisdiction of the Fed, the Comptroller of the Currency and the FDIC; or registered broker-dealers, subject to inspection and regulation by the SEC and self-regulatory organizations. The SEC also has the authority to sanction these firms and anyone else that engages in fraudulent securities activities. Finally, virtually all financial institutions which purchase government securities are subject to regulation by state or federal agencies or are governed by state or municipal statutes.

The Problem: Over the past seven years, the widely publicized failures of seven small government securities dealers, including within the past month ESM and BBS, have had repercussions throughout the financial markets.

The SEC estimates that over $500 million of losses (before taxes, insurance and civil suit recoveries, if any) have been sustained by the firms and institutions that dealt with ESM and BBS. Such losses have been attributed principally to: fraudulent concealment of ESM's and BBS's financial conditions; their use of the same collateral for multiple transactions; and, in the case of ESM, over $200 million of its $300 million of losses have been attributed to transactions with two thrift institutions that were under the control of the same individual.

The question is, "How can such losses be inhibited, reduced or prevented on a cost-effective basis?"

On March 21, 1985, the Commission indicated at hearings held by the Telecommunications, Consumer Protection and Finance Subcommittee of the House Committee on Energy and Commerce that it would review the regulatory structure of the government securities markets, in consultation with the Federal Reserve Board and the Treasury; and report its views to Congress by June 21st, regarding possible cost-effective modifications of the current regulatory scheme, taking into account the critical importance of this market to U.S. monetary and fiscal policies.

This work has begun. Senior members of the Commission staff and I have met with Chairman Paul Volcker of the Federal Reserve Board, Secretary of the Treasury James Baker, and members of their staffs.

The Commission approved publication yesterday of a release, seeking comments on the following questions:

A threshold question is the reaction in the marketplace to the widely publicized ESM and BBS failures. Are those who deal in the government securities markets now properly perfecting their collateral? Are they shifting from small to large dealers? Are there likely to be more failures as a result of an overreaction?

If greater regulation is necessary, which of the following alternatives would be the most cost-effective? Which would reduce or eliminate mistakes and deceptions at the least cost?

Should dealers be required to deliver through the Fed's or other book-entry systems, government securities that are transferred or pledged under repurchase agreements?

Should the Fed's proposed voluntary capital-adequacy guidelines for government dealers be made mandatory? Should those guidelines be expanded to include voluntary registration and segregation of customer positions subject to audit and inspection by the Fed?

Should a self-regulatory organization be created under the aegis of the Fed -- or the SEC? Or should the authority of the Municipal Securities Rulemaking Board, under the SEC's oversight, be expanded to include government securities markets and dealers? What responsibilities and authority should an SRO have? Should its authority be limited to imposing financial and operational requirements or should it also be authorized to regulate the business practices of government securities dealers?

The Commission also plans to invite the most knowledgeable source to amplify their views at an open meeting on May 22nd. Through the release, the open meeting and consultation with the Treasury and the Fed, the Commission intends to obtain the views of the securities industry, federal regulators, and others concerning the relative merits of the present and alternative forms of regulation of the government securities markets. The Commission will then attempt to quantify the costs and benefits of the various alternatives, and will submit its conclusions to Congress.

It would be premature to speculate on the many complex possibilities before the best available facts have been obtained and analyzed.

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Senator D'AMATO. No, no, no, Mr. Chairman. I am most interested in the latter part of your presentation, and I am wondering if you would explain to the committee why you think, in a little more detail, why a Government-supervised, self-regulatory organization would increase the Government's borrowing costs?

For example, it would seem to me if you had a municipal securities rulemaking board undertake this oversight responsibility in a little more detailed charge, that, if anything, it would provide market stability, and certainly I don't see how it would impair the efficiency of the market and raise costs $2 billion.

Mr. SHAD. No, I wouldn't suggest that it would. We don't have a basis for an opinion as to what the actual costs would be, nor the benefits.

I think the issue we have to do more homework on is whether it would be cost effective. We could have a lot more regulation. The question also would go to what extent would it influence business conduct. That is where it starts to add costs, not the fact we require registration of these firms nor that we require audits.

In fact, ESM and BBS were reporting on a monthly basis to the Fed, and the broker-dealer, ESM, was being audited, but fraudulently we contend. BBS, the broker-dealer, was being audited by Todman & Co. The Government-dealer was not, but the point is I see us at a crossroad. There are two options. Maybe you apply resources both ways at the same time.

OVERSIGHT—PREVENTIVE MEDICINE

One is preventive medicine, to stop it from happening in the first place; the second is to try to catch it when it is happening.

Now, the latter can be very difficult and expensive. We have a full panoply of regulations that we now have over the broker-dealers which essentially are primarily dealing with the public at large, an unsophisticated mass of 42 million investors, as distinct from those dealers who are primarily dealing with other corporations and institutions as well as municipalities, which sometimes aren't all that sophisticated in the way they conduct themselves.

But the second market we are talking about is a professional market where, by and large, all the parties have professional advice and assistance.

Senator D'AMATO. Chairman Shad, let me tell you about my own little school district in Island Park, School District No. 31, which has a basic elementary school and a junior high school and all the students go to another high school, and they were investing in these repos.

There's an action against that little school district now. They got their $1 million back, but the question is whether or not they received preferential treatment, and the Federal bankruptcy judge is looking at it. They are most unsophisticated.

Mr. SHAD. I appreciate that.

Senator D'AMATO. You've got a little local treasurer in some of these municipalities, and these villages and even some of the cities, and he's trying to gain as much income as he or she possibly can with their municipality for their school district or for their water district.

We have another village in upstate New York hooked for about $11 million. So these are the most sophisticated. They're attempting to gain as much as they can in terms of interest income, so they invested in this market, this tricky market. But let me ask you something. I don't think we can rely simply on customer education. Certainly more people are going to be aware, I would hope, but there were a series of these failures several years ago and yet they continue on. I don't think we can rely on just educating unsophisticated investors. Don't you think the savings and cost associated with dealer failures will be lower than any minimal increase in cost that would eventually be felt in borrowing?

Mr. **Shad.** It would be easy for me to say yes, but I really want to give you a well reasoned response, and we have engaged in a major responsive effort to try to come up with a quantification for that purpose. Let me give you an example of just one little thing.

Last year we revised the shelf registration rule to permit corporations to put on the shelf prospective securities to be sold, almost an insignificant change in terms of regulatory aspects of it. We know that that is saving those corporations well over $1 billion a year in underwriting and interest costs.

Now, what if you reversed it? What if today we say well, there are some problems there, let's get rid of the shelf rule. It would be damn difficult to determine the cost of such a change. It's almost an invisible film when you change business conduct by regulation as to what the real cost of it is. It's not easy to quantify.

And that is an example of a very simple decision. It was very controversial, frankly, at the time, because it had economic impact. But in any case, it's so easy to pass a rule that doesn't seem to be very pervasive or just the reverse in this case, the shelf rule, and really put a hell of a lot of cost into the system. So I can't answer you with a considered opinion.

But I do want to make the point that these two failures have been on the front page of virtually every newspaper in the world for the past 10 days, if not longer. In fact, it goes back to early last month.

In the past, when these kind of things have occurred, there's been an enormous reaction in the marketplace. The market reacts so much faster than we can as regulators or you as legislators.

COLLATERAL IS THE FUNDAMENTAL PROBLEM

One of the fundamental problems, I believe, about this whole situation has been collateralization. You can have an overreaction that could actually exacerbate the problem if people really tried to demand full delivery. You can't have full physical delivery of Government securities, most of which are on a book entry basis—high speed, very low cost methods of recording transfers of ownership.

The question is, Can you adapt that to the repo market, which is the pledging of an interest? Can we also get that on the Fed's wire or a self-regulatory—or other private electronic book entry systems.

I don't know what the cost is. It could well be more expensive than the direct costs of regulation. Right now people are dealing in confidence in this market on the basis of a confirmation, a piece of paper that says that we bought or sold this for you, and if it's a case of a repurchase agreement, the collateral is being held in the case of ESM, at Bradford Trust.

Unfortunately, it didn't all prove to be there. What I'm trying to say is the public is reacting now. We know that people, such as the school districts you mentioned, are shifting from the little, local dealers to the major names, the primary dealers. Before, they were getting a list of the yields payable—they were getting them from money market brokers, showing yields available. If somebody they never heard of is willing to give them 25 basis points, they appear at the top of the list as the highest yield. They haven't been equating the fact that risk and reward go hand in hand.

Senator D'AMATO. But here you're dealing in Government securities. The U.S. Government is backing it and so why wouldn't a little school district treasurer take it into his or her head, my gosh, I can pick up 25 basis points more, I'm investing in the U.S. Government, it's a solid investment. That's why I think, with respect to what these firms are doing, their capital adequacy, their liquidity and adequate capital, et cetera. All of these kinds of things, why not subject them to a review system which the SEC has more input into?

I'm going to ask you one more question and then turn it over to Senator Cranston for his questions. In both of the most recent failures, ESM and Bevill, Bresler & Schulman, there seemed to be a certain pattern where you had an accountant—a major accounting firm—which came in, audited only one of a number of subsidiaries, leaving the way open for mischief at the other end.

Professor Briloff, a professor at Baruch College, refers to this accounting technique—and I think it's quite appropos—he says, "The rules let the piano player into the bordello, keeping his conscience clean by never walking upstairs to see the actual business."

You know, if I audit just this one part and don't look at the others, it's kind of like that piano player, and he says, you know, I can't tell you what's happening.

What about the propriety and wisdom of generally accepted accounting principles, please explain the Commission's authority to influence changes in the accounting standards?

Mr. SHAD. Well, we do have responsibility for the filing and disclosure requirements of publicly owned corporations and over the regulated entities, which includes most of the major dealers in this market—broker-dealers. But it doesn't include all of them. There is also the group of unregulated, unaccountable dealers.

But I think a very affirmative fact is today's Wall Street Journal article about the AICPA forming a task force to now come up with better ways, tougher standards in auditing procedures to confirm collateral.

PERVASIVE FRAUD

Now, when you get into a fraud, you know, we might have caught it earlier. We might have stopped it sooner, but when you get a pervasive fraud, it looks like multiple parties in collusion, including the auditors being bribed, why then—because here's what they have been doing up till now.

The auditor of the school district's books, for instance, would confirm whether or not the heavy interest in Government securities or repo existed and if they confirm it back and say, yes, we have a record of that obligation of the ESM to the school district, that's where it was stopped.

And now they're questioning whether they should go beyond merely accepting the opinion of the auditor. In the case of BBS, it was Todman & Co. whom we had previously sanctioned as a result of their being the auditors for Bell & Beckwith.

In that situation we alleged—and it's been proven to be—fraud—where it was a fully registered and regulated major broker-dealer subject to the whole panoply of oversight investigation by not only the SEC but the self-regulator organizations, and they got away with it for a long time before the SEC went in on an independent investigation and started pulling on threads and unraveled an outrageous fraud audited by Todman & Co., the same firm that was the auditor for BBS.

But, again, as you have said about the piano player, in the ESM situation they were auditing the pieces. There was a loophole there where there was a big receivable—actually a shell company that made it look like they had a net worth which, in fact, they didn't have.

In the case of BBS, the broker-dealer was being audited and was fully registered with the SEC, but the Government securities dealer was not, and I agree with you that that's a shell game where you keep moving them around and you have one that the pea isn't under, and we didn't catch it nor did anyone else. But when we did we brought sanctions against these firms. We started investigations. You know the story on those.

But, I'm trying to say I think that when you have the enormous publicity that this situation has had, the market reacts. It reacts today, not next month, and that's what's happening. The reports in the press are that people are pulling out of these small firms rapidly, and that may actually exacerbate the problem. It may cause more failures in the near future.

But in any case, they're moving from the small firms that are not well-known into the big ones right now, and the accounting profession is reacting to how can we do a better job of confirming the existence of collateral.

The Fed, ourselves, and the Treasury are coming up with "what about the Fed wire?" Can we put all of these transactions over one instant system of book entry so that we have a record?

The standard instruction is against delivery of the securities to my bank or to a depository, but it's been one way, almost like writing a blank check that's been going on. And understandably so, because they have confidence in the system. They get the confirmation. They're getting the same confirmations from the ESM's of this world as they get from Morgan Stanley and the biggest firms, and they accept it. They have confidence in it. And that has proven to be a disaster in many cases.

But I think that there is a real reaction of enormous proportions going on there right now, and what we're trying to suggest is that we're moving as rapidly as we can to try to get the best input we can from the victims, the school districts and others, the primary dealers, the various Federal regulators, and the people that are actually on the firing line of this marketplace, and we are going to come back to you with our considered recommendations which are going to try to come up with the most effective cost/benefit effective approach.

And it may well be a combination of these things—of trying to improve the collateralization side, which is preventive medicine, stopping the problem before ESM can get away with it, and, the other part, which is trying to catch them after they start to play games.

Senator D'AMATO. Senator Cranston.

Senator CRANSTON. Thank you very much, Mr. Chairman.

Chairman Shad, as you know, this year, the Banking Committee will be considering legislation involving additional bank involvement in securities activities. Last year, I voted against banks and thrifts having securities authority, and particularly the authority to underwrite mortgage-backed securities, because I thought that there was undue risk involved among other things.

BANKING DEREGULATION

In 1984, the Senate passed legislation which would have allowed banks to underwrite mortgage-backed securities.

How do you feel about bank involvement in that area?

Mr. SHAD. Well, I would agree with you that they can involve a greater degree of risk. But what we have supported is that such transactions be conducted within corporate affiliates rather than directly with the bank. In fact, we would favor affiliates of the holding company. They are subject to the full rules and regulations of the SEC, so they would be subject to those protections but also the bank regulators can control what the holding company or its affiliates do. And so I think it's within physical constraints and controls that exist, and our attitude has been that it would increase the competition in the marketplace.

There would be some benefits to the public as a result if it's properly regulated.

Senator CRANSTON. It has been suggested by some people that now might be a good time to repeal Glass-Steagall altogether. What is your opinion on that?

Mr. SHAD. The Commission as such has not actually addressed the concept of total repeal. We have supported proposed amendments and I need to look at the other pieces that I haven't really looked at to give you a considered response to total repeal.

Senator CRANSTON. Could you give me your thoughts in writing?

Mr. SHAD. In writing, yes.

[The following information was subsequently supplied for the record:]

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE COMMISSIONER

August 12, 1985

The Honorable Alan Cranston
United States Senate
SH-112 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Cranston:

In Chairman Shad's absence, I am enclosing the attached materials in response to a question concerning the possible repeal of the Glass-Steagall Act which you asked during the April 17, 1985 hearing of the Subcommittee on Securities concerning the Commission's authorization.

Sincerely,

Charles C. Cox

Charles C. Cox
Commissioner

Attachment

RESPONSE TO QUESTION OF SENATOR CRANSTON

Hearing of April 17. 1985

QUESTION. "It has been suggested by some people that now might be a good time to repeal Glass-Steagall altogether. What is your opinion on that?"

ANSWER. The Commission has not formally considered whether the Glass-Steagall Act should be repealed. The Act is a banking statute which the Commission does not administer. However, the Commission has supported carefully crafted modifications to the prohibitions of the Act, if they are accompanied by limitations designed to minimize potential abuse.

In this connection, the Commission has taken the position that if new entities wish to participate in the securities business, they should do so subject to the full panoply of the securities laws -- that is, under a system of functional regulation. Functional regulation would neither promote nor deter the crossing of traditional lines between the banking and securities industries. It would, however, fill a gap in the current regulatory framework by providing public investors the protection of the securities laws regardless of the type of financial entity investors use for their securities transactions.

Consistent with this principle, the Commission previously has supported legislation that would make limited modifications to the Act. For example, the Commission supported S. 2181, introduced by Senator Garn, which would have permitted banks to engage in a limited number of new activities through holding company affiliates. These activities included underwriting municipal revenue bonds and sponsoring, advising and underwriting mutual funds.

Moreover, the Commission also recommended that, consistent with the principle of functional regulation, all bank brokerage activities marketed to the general public should be transferred to securities affiliates. */ In addition, the Commission has made specific recommendations to address potential conflicts of interests between banks and their holding company affiliates, if banks are authorized to engage in additional securities activities.

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*/ On July 1, 1985, the Commission adopted Rule 3b-9 which requires banks that engage in certain brokerage activities to conduct those activities through a registered broker-dealer.

Senator **Cranston**. In the matter of takeovers, I want to read something you said a while ago:

> Corporate takeovers and buyouts are financed through large loans. The net effect is that the debt is being used to retire equity, which is known as leveraging up a company's capitalization. The greater the leverage, the greater the risks to the company, its shareholders, creditors, officers, employees, suppliers, customers, and others.* * * The more leveraged takeovers and buyouts today, the more bankruptcies tomorrow. During the past few years, the multibillion dollar premiums shareholders have received in leveraged takeovers and buyouts have been a multiple of their losses from acquisition-related bankruptcies. The premiums come first, the consequences later. The leveraging-up of American enterprise will magnify the adverse consequences of the next recession or significant rise in interest rates.

Yet, at this time, the Commission is not supporting any legislation and seems therefore perhaps to be agreeing with the view of the Chicago School of Economists that legislation is not necessary.

Why? What is your view as to the value or the risks involved in takeovers, whether we should do something about that?

Mr. **Shad**. We have never proposed legislation or, in fact, been involved in any legislation involving credit control or that aspect of it. We did, last year, propose five measures dealing with takeovers, basically, hostile tender offers. And, yet, we have seen again that there's been an enormous reaction in the marketplace to many of the things that were perceived to be bad.

That speech you just read—I have had meetings with the boards of directors of Morgan Guarantee, Chemical, and major banks and others, and I'm being told that they're being much more selective and approaching these issues on a different basis than they were before.

Chairman Volcker has also spoken out on it, and we are being told that the banks are reacting to it.

JUNK BOND MARKET

Another area that is looming enormously is a so-called junk bond market, which is a different avenue to capital. Those bonds are being sold, however, to S&L's and others. They had an excellent experience to date, but I think maybe they're getting overconfident as to the future when they start to deal in multibillion dollar junk bond markets.

The junk bonds, of course, over a long period of time, have had yields which more than covered the default experience on them, and they tend to be upgraded over time if the companies do well. So that is why confidence has been building in the market. But, in these proportions it's now a matter that I think warrants consideration.

And I noted that, yesterday, Preston Martin raised questions concerning that aspect of the leveraging up, if you will. There are many examples of the serious consequences of companies using bond money to very aggressively acquire other companies. And it doesn't have to be through tender offers.

You've got the failure of a charter corporation and others that have essentially borrowed money to retire other people's equity. Many of these transactions are self-financing; substantial untapped borrowing capacity in the target is used to acquire the target.

I would say, in the absence of more evidence of serious consequences that could be building in this area, we would have more confidence in the market's reactions and the prudence of the market. I mean, the banks are going to be very concerned about extending their exposure. They believe they're making sound loans.

I haven't worked out the market's reaçtion because it's become so much more sophisticated and faster than some of our regulations—by the time they get on the books they are outmoded and there are new ways of doing it.

I can cite several examples in terms of the legislation we proposed last year. Just the mere raising of the legislation, the proposal of it, has caused an enormous response.

Senator CRANSTON. In regard to the Pickens effort that relate to Unocal now, the target on the one hand, that has been a benefit to the stockholders presently in Unocal because stock that was at something like $34 it then went up to $51. Is it therefore beneficial, in your opinion, to the stockholders and is it therefore beneficial to everybody?

Mr. SHAD. I think in the debate you've got this huge premium built up front in all of these major transactions, and that's a real fact; and in fact it is capital formation in my opinion. If somebody is willing to pay an enormously higher price, that money gets reemployed in the system almost instantly. So you've got to make the case that the downside risks or the longer term consequences more than offset this here and now reality of capital formation, and that's kind of a tough argument to carry.

Senator CRANSTON. Do you think the downside risks outweigh those temporary advantages?

Mr. SHAD. No; I don't have a considered opinion on that. I know the benefits, but I'm very uncertain, about the downside risks in the future.

Senator CRANSTON. What are the benefits?

Mr. SHAD. The benefits have been billions of dollars of enhanced purchasing power of value added that's been immediately reemployed in the securities markets, these huge front-end premiums that make it move. They're the thing that make it happen and that's very real. That's not ephemeral. The risk is very indefinite and uncertain, so you take a multibillion-dollar benefit and you try. So far, as you quoted there, the front-end premiums have been an enormous multiple of the subsequent losses by those companies that have gone into receivership as a result of highly leveraged acquisition programs.

You've got almost the certainty of the reality of one versus the uncertainty and perhaps adverse consequences of the other.

ENFORCEMENT ON SCHEDULE 13D

Senator CRANSTON. If the group buys some stock in a corporation and reports to the SEC in its schedule 13D that the purchase is for investment purposes only and not for a takeover, and then proceeds not too long afterward to launch a takeover effort, what does the SEC do? What is its obligation in that kind of a situation?

Mr. SHAD. I would like to ask John Huber whether we've actually issued stop orders in that circumstance.

Mr. **Huber**. Senator, if the statement of intention that they were going for investment was false at the time of the filing——

Senator **Cranston**. I beg your pardon?

Senator **Proxmire**. Pardon me, sir. Would you identify yourself for the record so we know.

Senator **D'Amato**. Why don't you just sit up here?

Mr. **Shad**. This is John Huber, the Director of the Division of Corporation Finance, with which these 13D's are filed. But just answer my brief question first, John. If somebody gives a statement of intent which is for investment and shortly thereafter goes for an acquisition, have we issued stop orders in any of those situations?

Mr. **Huber**. We have made enforcement referrals in those situations.

Senator **Cranston**. Would you use the mike and repeat your answer?

Mr. **Huber**. We've made enforcement referrals in those situations. The statement by the acquiring person that he is going for investment is a statement of present intention. Intention may change. If you have a situation where a group says, "We're investing as a passive investor," and very shortly thereafter goes for control of the company, that's a red flag to my division. It's something that we review and comment upon. And if indeed at the time they made the filing they had a plan to go for control, that's a matter that we view very seriously, and we do refer that to the Division of Enforcement.

Mr. **Shad**. Then, Senator Cranston is asking what action we take in these circumstances?

Mr. **Huber**. We bring enforcement actions for an injunction, and the injunction would prohibit them from violating schedule 13D again; and in the past we have also asked for remedial relief such as sterilization of the vote and in some cases divestiture of the securities.

Mr. **Shad**. Senator Cranston, I would like to add that I have a real problem with the very point you've made. I think that whether or not somebody gets hung up, if you want to call it that, on a 13D filing on the statement of intent depends on what lawyer drafted it. You've got situations where very experienced and capable attorneys draft those statements and they really have every option by the time you finish the paragraph of "in the case of this" and "what if that". So I have had some reservations.

On the other hand, most people would argue that it's better to have a statement of intention in there than not. But I think the efficacy of it depends on who drafted it.

Senator **Cranston**. The SEC in an amicus curiae brief filed with the fifth circuit in the case of *Gearhart Industries* v. *Smith International* informed the court that the SEC's resources are inadequate to police the many schedule 13D filings for the truthfulness of the disclosures. Is that the present situation?

Mr. **Huber**. We have many thousands of amended 13D's filed every year, Senator. It's not just the initial filing. It's the amendments. And every time there's a material change in the information an amendment is due and owing to the Commission.

We have traditionally taken the position—concerning the Williams Act and also the proxy rules—that private rights of action are necessary for the enforcement of the provisions, and the Federal securities laws generally. So, our amicus position has always been to support private rights of action. So *Gearhart* is consistent with that.

Senator CRANSTON. But do you have the resources to really look into all these filings? For example, what percentage of schedule 13D and 14D filings in the last year were essentially unreviewed or barely reviewed?

Mr. HUBER. Very few of the 13D's receive a full review, but in a takeover we look at the 13D's in connection with our review of all the other tender offer materials. So in that regard, they are looked at when a takeover is going on.

Senator CRANSTON. Thank you very much. My time is up.

Mr. SHAD. I think that the important ones are reviewed and a lot of them are routine type amendments where there haven't been problems subsequently.

Senator CRANSTON. Thank you very much.

Senator D'AMATO. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman. Mr. Chairman, before I go any further, I've got a brief opening statement that I'd like to have incorporated in the record today at the appropriate place.

Senator D'AMATO. So ordered.

OPENING STATEMENT OF SENATOR SASSER

Senator SASSER. Thank you, Mr. Chairman. The Securities Subcommittee will hear testimony this morning on a recommended 3-year authorization for the Securities and Exchange Commission. Recent events have focused attention on the need for a sound regulatory framework for the Nation's securities markets.

In a deregulated environment, the threats to safety and soundness in our financial structure are more pronounced. The material submitted by the Chairman of the Securities and Exchange Commission anticipates a good deal more deregulation than is currently in effect, the assumption being that deregulation requires more, and more effective oversight. While I am not quite as convinced as Chairman Shad of the inevitability of all the legislative action he anticipates, I believe his point is well taken: it's usually in another context that we hear the phrase: "The price of freedom is eternal vigilance." But I believe it applies to the securities markets as well.

I am frankly somewhat concerned about the level of vigilance we have now, in our current environment—and I will have some questions in that regard.

Thank you, Mr. Chairman.

COMPLAINTS OF ACCOUNT CHURNINGS

Chairman Shad, it's my understanding that Commission members and staff are encouraging the New York and American Stock Exchanges and the National Association of Securities Dealers to handle more of the complaints themselves against brokers who churn clients' accounts.

Is there any truth to these reports and, if so, what actions do you expect these self-regulatory organizations to take, and are complaints of churning on the rise?

Mr. **Shad**. Pardon?

Senator **Sasser**. Are complaints of account churning on the rise?

Mr. **Shad**. Yes. The total volume of complaints has been steadily going up over a long period of time. I haven't seen any direct correlation. I can't tell you exactly why, but undoubtedly these markets—we've gone from 20 million share days to 100 million share days—that has a lot to do with it. A large portion of the complaints are over receipt of dividend checks and whatnot.

Let me be directly responsive to the opening part of your statement. Yes, we are. The SEC, in my view, is an outstanding, highly professional group of people. It's only 2,000 people. It's a tiny agency, as Government agencies go, but by any criteria that I can bring to it, it's a keenly professional, highly motivated agency, steadily improving its productivity.

Now we can get an awful lot of leverage out of that talent and the relatively small budget we have by enforcing oversight by these other groups, including the NASD. They have far more examiners than we do. We spot check their exams. We go in ourselves, but basically we rely on them.

And in many of these cases, you're talking about one account executive in one branch office churning an account, and it's outrageous for the clients of that broker, widows and orphans who are badly abused. But it is only one individual in one branch office, and bringing the Federal cannons to bear on that kind of a gnat when a flyswatter would probably do the job is a less efficient way to pursue it.

We really press on the NASD in these business practice areas, as well as the stock exchanges. They are the principal self-regulators there.

Senator **Sasser**. So, you are encouraging the NASD and the Stock Exchanges themselves to handle complaints or more of the complaints against brokers who churn clients' accounts?

Mr. **Shad**. Yes; that's correct.

HOSTILE TAKEOVER VIOLATIONS

Senator **Sasser**. Mr. Chairman, recent hostile takeover activity has resulted in some serious securities law violations being alleged against corporate raiders. These include market manipulation, insider trading and so forth.

Now just the other day, CBS sued Ivan Boesky and their claim alleges the following—this is lawyers' language and I assume it's reasonably accurate—it says:

> Defendants have engaged

this is talking about Boesky—

> have engaged in a deliberate course of illegal conduct designed for the purpose of artificially and temporarily inflating the price of CBS stock owned by them and attempting to coerce CBS to purchase that stock at a premium over-the-market price.

It continues by saying,

> Defendants' unlawful activities include their purchase of CBS shares, utilizing finance methods prohibited by Federal regulation, and their failure to report that fact on the schedule 13D filed by them on April 1, 1985.

Continuing with the allegations against Boesky and his associates,

> Defendants' schedule 13D contains numerous other material omissions and misrepresentations concerning their true intentions. Defendants' unlawful conduct has resulted in the artificial and temporary inflation of the price of CBS stock and has caused undue volatility and instability in the market of CBS shares.

Now I know, Mr. Chairman, that you can't respond to any specific case, but I want today some assurance from you that the SEC is monitoring these takeover abuse allegations seriously and that the Division of Enforcement is highly sensitive to doing something about these allegations of market manipulation, order omissions, insider trading, and other serious security law violations. Can you give the committee that assurance today that you are responding seriously to these market manipulations?

Mr. SHAD. Yes, sir.

Senator SASSER. Could you amplify on that as to how you're responding.

Mr. SHAD. As you indicated, we can't confirm or deny what we're doing on some of these investigations because it would compromise our ability to achieve our responsibilities in some cases; in others, it would impugn innocent parties. But the litany here of charges that you have mentioned individually warrant careful—they are being monitored, and they warrant going beyond monitoring in some cases.

If you would like us to amplify that in more detail, I'd like to ask Acting Director of the Enforcement Division, Gary Lynch, to help.

Senator SASSER. Well, I'd like to hear from him.

Mr. SHAD. All right. Gary Lynch.

Mr. LYNCH. We are familiar with the allegations that you just read into the record. We also have generally become familiar with similar allegations in other cases. Either the attorneys for the bidder or the attorneys for the target bring the matters to our attention and then we have to make a determination as to whether or not to devote resources to a pursuit of it, and I think the determination that we make in the tender offer cases is the same type of determination that we make in insider trading cases, financial fraud cases, and any number of other cases.

We try to evaluate the facts brought to our attention to determine whether or not in our view violations of the law have occurred if the facts that have been brought to our attention are proven.

In a tender offer situation, for example, we would discuss that with the Office of Tender Offers in the Division of Corporation Finance to get their view as to the law and their view of the situation based on their review of the documents. But I would say that certainly over the past 4 or 5 years every major allegation that's come to our attention where it appears that there has been a violation of the securities laws, we have looked into. And sometimes it may end after calling counsel for the party against whom the allegations have been made and receiving a response that seems reasonable.

In other cases, we've gone to the point of subpoenaing documents, taking testimony on the record.

A question was asked earlier about the 13D cases. Do we bring action when someone has disclosed an intention to be a passive investor and then it later turns out that they want to make a tender offer.

We did bring a case last year against Mesa Petroleum, Mr. Pickens' company, because we weren't satisfied with the disclosures that they made with regard to their accumulation of stock in Gulf. In that case, we brought an action saying that they should have disclosed earlier that it was their intention to make a tender offer, and at the current time Mesa Petroleum is under a permanent injunction to comply with section 13D in the future.

Senator SASSER. In other words, when you get the allegation you make an examination and do an investigation and from that you make a determination as to whether you will get involved?

Mr. LYNCH. Yes.

Senator SASSER. Or whether the explanations are satisfactory and the allegations raised are not valid?

Mr. LYNCH. That's right.

Senator SASSER. So you have a decision there to get involved or not get involved.

NUMBER OF DECISIONS

Now let me ask this question. Has there been an increase or decrease in the decisions to get involved in recent years? In other words, are you getting involved more or are you being more satisfied with explanations?

Mr. SHAD. Could I partly answer that?

Senator SASSER. Sure.

Mr. SHAD. Certainly the volume of insider trading cases that we have been bringing and the related charges that were mentioned—the manipulation and others—has been going up. Last year, actually the percentage of our total cases went down but it was partly due to the fact that the numbers went up. So the increasing volume of tender offers has resulted in more enforcement cases that are relative to those tender offers because there have been more of them. We are constantly responding to the changing market conditions, and our standard is we don't make distinctions between who the parties are but, rather, whether we have a sustainable cause of action.

Senator SASSER. But you have got an increased volume of business coming at you from the enforcement standpoint; is that correct?

Mr. SHAD. Yes.

Senator SASSER. That raises another question that's of some concern.

Mr. LYNCH. I'm not certain that's true actually. If you just look at the absolute number of tender offers made in 1980 and 1981 versus today, I don't think you can say there's more today than there were in 1980 or 1981. They are bigger deals. They are for larger companies, but in terms of just the number of offers that are made, I'm not certain there are more today than in 1980 or 1981.

Mr. **Shad**. OK. I accept that.

Senator **Sasser**. Well, according to a recent GAO study of the SEC's enforcement program dated March 1985, the funding and staffing of the Enforcement Division, Mr. Chairman, during your tenure has decreased relative to the overall spending and staffing at the Commission as a whole.

Let me read from the GAO report.

Mr. **Shad**. I'm aware of that, and it's an inaccurate statement, but go ahead.

Senator **Sasser**. You say it's inaccurate?

Mr. **Shad**. Yes, it is.

Senator **Sasser**. Well, let me read it to you and you tell us where it's inaccurate. I would like to know that and perhaps we can correct the record on that.

GAO says:

> Although funding for both the SEC in total and the enforcement program increased during the years covered by our review, enforcement staff declined each year since 1979. During the 7-year period covered by our review, SEC's appropriation grew from $56 to $90 million, or 59 percent, while the enforcement program's funding increased from $21 to $30 million, or 47 percent growth, which would be about 12 percent less than the funding growth for other activities in the SEC. And during this same period enforcement staffing declined from 633 to 610, about a 3.6 percent decline. This compares with a decrease in total SEC staffing from 1,934 to 1,921, less than a 1 percent decline, during the same period.

Where are those figures in error, Mr. Chairman?

Mr. **Shad**. Well, in every meeting that I've participated with the Executive Director and the people who actually prepare our budgets and personnel allocations, we have had to take cuts in the period I've been at the SEC. Each time the cuts have been less in the Enforcement Division than in the Commission overall. In fact, I think less than any other area. In other words, we have tried to maintain the strength of the enforcement area at the expense in some cases of other areas.

Now what you just referred to may include allocations made at the regional administrator level. The regional administrators have major programs to handle, and if they have a problem—one of the strengths of the Commission has been the flexibility—if they have a problem in let's say small issue filings, where there's an enormous increase in the volume of S-18 filings of small offerings, they shift their personnel. Those people might otherwise be working on the straight enforcement effort might be put into the processing and the pursuit of violations in another area. And how you sort out those numbers, how you count them up—I can see where honest people could come to different conclusions.

But certainly at a policy level the reductions in the Enforcement Division have been about a third of that of the Commission overall. In other words, it's been a lot less than for the rest of the Commission.

Senator **Sasser**. Well, I don't mean to infer with these questions that we're critical of the Enforcement Division and its activities. Others may be but I am not at the present time.

ALLOCATION OF ADEQUATE RESOURCES

But my question really is, are adequate resources being allocated to the Enforcement Division of the SEC? Do you have the resources in the Enforcement Division to do the job that needs to be done? That's the question.

Mr. **SHAD**. Well, we could always do more with more, there's no question about that. And what we don't know— and this is true of every law enforcement agency—is the extent of undetected or unexposed violation. But what we are doing—let me give you just one example. We are now bringing—or we did for the fiscal year just ended—57 more enforcement actions per annum despite the staff reductions that have been going on throughout the Commission. We are running at a much higher rate.

How do we do that? Well, it's a combination of automation and paperwork reduction and better management by Mr. Lynch and the senior members on the enforcement side. We're using computer systems to track cases. We are trying to clean out dead wood, concentrate on those cases that really will serve to inhibit questionable conduct as opposed to, as was raised earlier, some of these business conduct cases involving a single account executive in a branch office somewhere.

My predecessor also felt that we should not pursue with the same resources so-called tax shelter cases where essentially the individuals are wealthy individuals that are professional and have adequate resources to protect themselves and especially when the cases are geographically limited in area.

So there are various efforts that we are engaged in to, in a sense, take maximum benefit of our resources. I can say that I know that we could do more with more, but I'm not aware of any sustainable causes of action where we really believe we've got the basis for an enforcement action that we have not gone full term through the course. Most of these cases are settled by consent, but I'm not aware of any where we believed that we had a sustainable cause of action where we didn't take it full term. We are prepared to go flat to the mat with the violators.

Senator **SASSER**. My time has expired. Thank you, Mr. Chairman.

Senator **D'AMATO**. Senator Proxmire.

FINANCING HOSTILE TAKEOVERS

Senator **PROXMIRE**. Thank you very much, Mr. Chairman.

Chairman Shad, this is kind of hostile takeover day in the Banking Committee. Senator Cranston and Senator Sasser both asked you about that. I want to proceed, too.

A number of stories have appeared just this week on the financing of hostile takeovers. Monday's stories indicated that Pickens had successfully lined up $3.9 billion of financing to help pay for the proposed acquisition of Unocal; Carl Icahn began his $324 million hostile tender offer for control of Uniroyal; and there were indications that Tiger International may face a proxy fight for control of its board from Reliance Financial Corp., which is controlled by Saul Steinberg.

Then in yesterday's papers there were headlines that Sir James Goldsmith has $850 million in financing for his hostile takeover bid for Crown Zellerbach Corp. And the list goes on and on and on.

I have two questions related to that activity. First, in one of these cases we are talking about an individual's raising a couple of billion dollars inside of 1 week and in the others we are talking about the raising of hundreds of millions of dollars on very short order. How can they do it?

Mr. SHAD. Drexel Burnham has had an incredible track record in the so-called—it's a pejorative term—junk bond market, but there are institutions throughout the country that have had very favorable experiences over an extended period of time in these low-quality, high-yield debt securities to the point where they can get on the phone with their people and contact the key participants fast, get them to commit, and then others will follow until they can put together almost a syndication that's created on very short notice. And it's because of the long-time successful experience of these institutions with these types of investments.

They are often paid a front-end fee for a commitment, in effect a stand-by fee, and they are prepared to move quickly and it's, again, an example of an incredibly efficient—and it's confidence—they have confidence in Drexel to properly structure the transaction so that it is sound financing.

Another way they can do it, incidentally, I want to hasten to add, is that in a high percentage of these cases—and I haven't looked at each of the ones you mentioned, but I would suspect that the common denominator is that these companies have untapped borrowing capacity themselves which is used to finance a big piece of the purchase price.

Senator PROXMIRE. Well, I wish I could somehow share your optimism about this. I have great respect and admiration for you and your agency. I think it's a great agency and I think you're a fine Chairman. But I must say that I feel as if I'm talking to Dr. Pangloss, you know, in Candide—everything is for the best in the best of all possible worlds. No matter how much these fellows get into it, it seems to me you can always see a silver lining, and you say this is somehow increasing the capital stock. I think it's just a matter of sheer inflation, plus the fact that these firms are getting terribly in debt and I think it's going to be a very, very serious problem when we have the turndown in the business cycle which we can always expect.

Mr. SHAD. I have the greatest respect for your sensitivity to the issues and the way you characterize them, but I have to say that I don't think I was expressing optimism. I thought I was explaining how the thing works.

Now another topic is, whether there's going to be a day of reckoning in this area. And earlier, in response to another question, I did indicate that this market—fundamental studies were done about 15 years ago—I participated in some of them—that were impressive, very convincing, that the yield differential on low-quality bonds throughout the depression and all the serious periods in the past more than compensated for the default risks. In other words, the number of ones that went belly up. And also, that junk bonds tend to get upgraded. There's a certain percentage of them that improve as time goes on, and they get higher quality ratings which enhances their market value, whereas AAA bonds really have only one way to go; they can't get a higher rating and some do get rated down. So there's been that study, that basic analysis, which was a very broad analysis of the high-yield bond market, that convinced a lot of people.

Now like a lot of things, they get carried to extremes. And today, you've got—as in the examples you cited—such enormous amounts of money are going into this type of investment, the question is, is it being overdone?

Senator PROXMIRE. Now that's exactly right. Aren't we coming to the point where enough is enough?

Mr. SHAD. Well, I can't answer you because we haven't done the analysis, but it's not an area of lack of concern or interest. We have not done the analysis to determine that, and, of course, we are not in a merit regulation business. The Commission does not have the authority to say go and no-go to different financing plans. Our job is full disclosure and let the marketplace make those decisions.

Senator PROXMIRE. Well, yesterday, as you say, you referred to Preston Martin's position of yesterday. As you know, he's Vice Chairman of the Federal Reserve Board and a free marketer, like you are. He urged that all federally insured savings institutions and banks be barred from purchasing junk bonds which as you know, as you just pointed out, are used to finance takeovers. I happen to agree with Preston Martin. Do you agree with him?

CAREFUL ANALYSIS JUSTIFIED

Mr. SHAD. I haven't done the analysis to conclude that I disagree or agree. I think there's certainly justification for careful analysis of what's going on there. It slops over into this whole Government bond area where prime credit but not supported by the dealer's credit. I think these are critical areas that warrant careful review, but I'm not prepared to say that no S&L should buy a high-yield debt security. Some of these are extremely attractive, both in terms of their protection as well as the above-average return.

Senator PROXMIRE. They may well be but, of course, an S&L is a depository institution and it's not an institution that most people feel should be taking big risks. Its principal function is to finance housing and junk bonds seem to be a way to get in trouble.

Mr. SHAD. There's a tradeoff. The basic real estate financing by the S&L's lacks liquidity. Junk bonds are usually very liquid investments. They are readily marketable. And when you want to get out of a nonmarketable interest, it usually has to be at a deep discount, whereas if it's marketable you can often move it out at current prices.

Senator PROXMIRE. Let me ask you quickly about some other aspects of the SEC. What's the difference between the Office of the Chief Economist and the Director of Economic Policy and Policy Analysis?

Mr. SHAD. The Chief Economist is looking at broad economic issues. The Director of Economic and Policy Analysis is looking at much more specific problems and also running all of the statistical services that relate to the focus reports that are filed with us by broker-dealers, and other reports.

Senator **Proxmire**. Now you talked about the fact that you have a relatively very small agency.

Mr. **Shad**. Yes.

Senator **Proxmire**. And a very high class agency. I think that's right. But you know the President's view of economists. The Council of Economic Advisers has a total staff of 34. At OMB there are eight in the Office of Economic Planning. According to your numbers, the SEC has a total staff in its economic division of 43.

Why do you need more staff in this area than the President or OMB?

Mr. **Shad**. Well, I don't think all of them—they're certainly not economists. There are a lot of statisticians and others that are in those total numbers. That includes both the Office of the Chief Economist and the Directorate of Economic and Policy Analysis, which publishes reports, statistical surveys, data that is assembled throughout the year, handles our paperwork reduction rule requirements and does a whole variety of ongoing fundamental work for the Commission. I don't believe that's economic analysis in the sense that you're using the term.

Senator **Proxmire**. Well, let me ask you if your economists can go to work in one area that you may not have been able to get into yet.

It's my understanding that the committee is highly sensitive to costs imposed on business and is very cost-benefit analysis conscious. Have your economists done any studies of the costs imposed on business of fending off and defending against hostile takeovers, like attorneys' fees, investment bankers' fees and so forth?

Mr. **Shad**. Not to my knowledge.

Senator **Proxmire**. Could you give us a report on that?

Mr. **Shad**. I can ask them right now if Gregg Jarrell would just give me a yes or no. Have we done anything in analyzing the cost of defending against tender offers?

Jeff Davis. I'm not Gregg Jarrell, but the answer is no.

Senator **Proxmire**. Well, would you consider doing such a study in view of the fact that this is such an absolutely critical—you and I both agree that there's a point where enough is enough, as you indicated, and certainly one of the most important elements of this is knowing what the cost is. Wouldn't it be helpful to have that kind of a study.

Mr. **Shad**. It would, but honestly it would probably require additional staff that we don't have. These are very serious efforts that we engage in and when the Office of the Chief Economist has come up with a statement it's been based on indepth surveys and analyses, so that we could give a superficial type of thing, but to do a really meaningful effort would probably require us to engage somebody from the outside to help us or divert people from ongoing efforts that have got high priority.

Senator **Proxmire**. Well, my time is about up. The chairman has very graciously allowed me to maybe ask one more question.

Could you suggest to us how we might have a study made if the SEC can't do it? Is there some other body that can do it? As I pointed out, the Council of Economic Advisers has fewer economists than you have, and so does OMB.

Mr. SHAD. Well, I hope we can accommodate you, and if we can't, we will come back with a different way to do it, yes.

Senator PROXMIRE. All right, fine. My last question is this.

Periodically, the charge is made that the Commission——and I stress the Commission rather than the professional staff of the Division of Enforcement—is soft on enforcement and that, of course, was asked by Mr. Sasser too, but I'd like to follow up in a different way.

NUMBER OF ACTIONS

How many times has the Division of Enforcement recommended bringing an action and been voted down by the Commission?

Mr. SHAD. A very small percentage. I can't give you the exact count, but it's a very small percentage.

Senator PROXMIRE. Could you outline just a few instances where you have decided against bringing an action where the Division of Enforcement thought one should be brought?

Mr. SHAD. I can recall one involving a failure to supervise, case where in a huge firm, one account executive in one office did some outrageous things and I questioned whether or not it should result in the whole firm reading headlines in the Wall Street Journal that they were not properly supervising their people. I thought it didn't rise to the systemic level that would justify charging the firm. But the Commission charged the firm.

Senator PROXMIRE. So you only recall that one instance?

Mr. SHAD. Oh, well, I'm sure there are others, but that was a notable one.

Senator PROXMIRE. Would you for the record indicate over the last 2 or 3 years what cases you have overruled the Enforcement Division?

Mr. SHAD. Well, I don't overrule them.

Senator PROXMIRE. Well, I mean the Commission has overruled the Enforcement Division, where they made a recommendation and you've said you can't agree with them. Of course, you have to assume responsibility and it's up to the Commission to decide whether to go ahead, isn't that right?

Mr. SHAD. Yes, but that was a situation where the Commission went ahead despite—I was of a different viewpoint. Let me say two things. One, the number of times the Commission has not gone along with the staff is an insignificant, in my opinion, percentage of the cases we review; and second almost all the Commission decisions are unanimous to support the staff's recommendations.

Senator PROXMIRE. Well, what I would like for the record is the number of times in the last 3 years that you have decided against bringing an action where the Division of Enforcement thought one should be brought.

Mr. SHAD. Where the Commission as a whole has in effect voted it down?

Senator PROXMIRE. That's right.

Mr. SHAD. Fine. We will do that.

[The following information was subsequently supplied for the record:]

OFFICE OF
THE COMMISSIONER

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

August 12, 1985

The Honorable William Proxmire
United States Senate
SD-530 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Proxmire:

In Chairman Shad's absence, I am enclosing the attached materials in response to two questions which you asked during the April 17, 1985 hearing of the Subcommittee on Securities concerning the Commission's authorization.

Sincerely,

Charles C. Cox

Charles C. Cox
Commissioner

Attachment

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Question 1. [W]hat I would like for the record is the number of times in the last three years that you [the Commission] have decided against bringing an action where the Division of Enforcement thought one should be brought.

Answer. In response to your inquiry, the Commission's Office of the Secretary has reviewed the minute records for the relevant periods. Those records are indexed by name and not by action taken or not taken by the Commission or individual Commissioners. While we cannot be absolutely certain that no Commission actions were overlooked, we believe this response to be an accurate statement of Commission actions taken during the period from October 1, 1982 through May 14, 1985.

The following chart indicates by year and type of action the number of times the Commission has approved, disapproved and modified recommendations of the Division of Enforcement.

COMMISSION ACTIONS IN RESPONSE TO RECOMMENDATIONS BY THE DIVISION OF ENFORCEMENT

	FY '82	FY '83	FY '84	FY '85
Injunctive Actions:				
Approved as recommended:	136	151	179	52*
Disapproved	2	2	0	0**
Administrative Proceedings:				
Approved as recommended:	106	94	114	59*
Disapproved	2	1	1	1**
Section 21(a) Reports:				
Approved as recommended	3	2	2	0*
Disapproved	0	0	1	0**
Formal Orders of Private Investigation:				
Approved as recommended	137	152	113	76*
Disapproved	0	1	1	4**
Recommendations (of all types) approved after modification by the Commission***	6	10	9	7**

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* Through March 31, 1985.

** Through May 14, 1985.

*** These modifications are limited to cases in which the Commission deleted proposed violations or defendants.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Question 2. Have your economists done any studies of the costs imposed on business of fending off and defending against hostile takeovers, like attorney's fees, investment bankers' fees and so forth?

Answer. The costs and benefits associated with tender offers have been examined by the economists at the SEC. It should be pointed out that the costs to which you refer -- attorney's fees and the like -- are a small fraction of the overall magnitude of the net benefits associated with successful tender offers, or the net cost of failed ones.

Senator Cranston has submitted a written question which is virtually identical to yours, as well as a closely related second question. In view of this similarity, we are enclosing a copy of our reply to Senator Cranston along with some accompanying documents, including some of our published studies of this issue. We apologize for giving you the erroneous impression at the hearing that we have not examined this issue.

RESPONSE TO QUESTIONS OF SENATOR CRANSTON

Hearing of April 17, 1985

Question 1. What studies have been undertaken, and what statistics are available regarding the costs to business involved in defending against takeovers?

Answer. We know of no studies that have attempted to measure the direct legal and other costs involved in devising and defending against hostile tender offers. However, on average, such costs must necessarily be small in relation to the total social cost of failed tender offers (or, for that matter, to the total social benefit of successful tender offers).

One large directly measurable social cost of defending against takeovers is the capital loss to target and bidder shareholders that occurs when the defense causes the defeat of the takeover attempt. The statistical evidence is very strong here. The SEC's Chief Economist, Gregg Jarrell, has authored two published studies on this question. 1/ The data show on average large and "permanent" stock price declines are caused when target firms reject tender offers to remain independent. Also, in response to an article

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1/ See the two enclosed articles: "The Wealth Effects of Litigation by Targets: Do Interests Diverge In a Merge?" Journal of Law and Economics 28:151 (April 1985), and (with Frank Easterbrook) "Do Targets Gain from Defeating Tender Offers?" New York University Law Review, 59:277 No. 2 (May 1984).

drawing the opposite conclusion appearing in Forbes, the Office of the Chief Economist recomputed the stock price evidence and showed that in 88 percent of the cases surveyed in that article, target shareholders suffered large capital losses. 2/ These losses take the form of forgone capital gains that these shareholders could have enjoyed had the offer not been defeated. This same point is demonstrated in yet another study by the SEC's Office of the Chief Economist which examines the various impacts of tender offers. 3/

Another major cost to shareholders of defense from takeover is the payment of "greenmail" -- a premium (above market) payment to buy out a large individual shareholder. The SEC's Office of the Chief Economist has released an economic study of these targeted share repurchases which shows that for the 89 greenmail cases occurring during the period from January 1979 to September 1983, a total of over one billion dollars in above-market premiums was paid out to large block shareholders. 4/

2/ See enclosed April 1, 1985 memo by Gregg Jarrell, et al.

3/ "The Economics of Any-or-All, Partial, and Two-Tier Tender Offers," Office of the Chief Economist, SEC (Washington D.C.: April 1985).

4/ "The Impact of Targeted Share Repurchases (Greenmail) on Stock Prices," Office of the Chief Economist, SEC (Washington, D.C.: September 1984).

Another cost of defending against takeovers is that associated with antitakeover charter amendments. The Office of the Chief Economist has released a study focusing on this subject. 5/ In addition, the SEC's economists are continuing to examine this issue using a large updated data base containing over 600 cases of post-1979 antitakeover amendments. We expect a follow-up study to be released within a few weeks. The research so far indicates that supermajority type provisions and "poison pills" impose substantial capital losses upon shareholders. These capital losses represent a major cost of deterring takeovers. Fair price amendments, which have dominated the market since 1983, are not associated with such large stock price declines.

5/ "Shark Repellents: The Role and Impact of Antitakeover Charter Amendments," Office of the Chief Economist, SEC (Washington, D.C.: September 1984).

Question 2. Chairman Shad, you have a division of Economic and Statistical Research of some 43 people. Why don't you conduct a study of the effect and cost of hostile takeovers to business?

Answer. The office at the Commission which produced the previously mentioned studies is the Office of the Chief Economist. There are six professional economists on their staff, assisted by a research support staff of five additional individuals.

With respect to a study of the effect and cost of hostile takeovers to business, our Office of the Chief Economist has, as a matter of fact, produced several studies which deal in good measure with this issue, some of which are listed in our response to your first question.

In particular, we have addressed the correctness of the very arguments which you made a basis for your questions -- that business decisions are influenced by whether they will increase or decrease a company's vulnerability to takeover and that threat of takeover forces management to focus on short term rather than long term results.

This theory is based on the notion that the equities market is increasingly dominated by institutional investors who focus on short term results. This theory further alleges that because of these short run minded professional money managers, firms are forced to forego expenditures on R&D in order to boost current earnings at the expense of future earnings in an effort to drive up the price of the stock and ward off takeover. Our office of the Chief Economist has produced a study which contradicts this theory. 6/ The data show, for example, that increasing institutionalization is, on average, accompanied by increasing expenditures on R&D. In fact, the data show that institutional investors generally seem to favor firms with higher R&D ratios. After accounting for industry differences, changes in institutional holdings appear to be unrelated to changes in R&D expenditures. Further, announcements of new R&D expenditures are generally greeted with favorable stock market reactions. This evidence also reveals that firms which became targets of takeover attempts between 1980-1984 generally had lower, not higher, R&D to sales ratios than other firms in their industry. Also, these target firms tended to have roughly the same R&D to sales ratios in the year prior to the tender offer as they had in the prior three years. Finally, these takeover targets are characterized by low institutional holdings, which contradicts the theory that money manager shareholders were responsible for the eventual takeovers.

6/ "Institutional Ownerships, Tender Offers, and Long Term Investments," Office of the Chief Economist, SEC (Washington, D.C.: April 1985).

Senator **Proxmire**. Thank you.

Mr. Chairman, I want to say I'm delighted to cosponsor the bill that's been introduced by Senator Cranston and I understand you and Senator Cranston are introducing legislation to regulate the Government securities market and I agree with you and I congratulate you on that.

Senator **D'Amato**. Let me say to Senator Proxmire, we will be reconvening or rather holding another hearing by this subcommittee on May 2, at which time we will hear testimony from Gerald Corrigan the President of the Federal Reserve Bank of New York, on the issues surrounding the regulations of Government securities markets and what should or should not be done. We hope that we will be able to get some additional data and recommendations also from the SEC and from Chairman Shad and his people, and we will also be examining the proposed legislation of Senator Cranston. I have indicated that I do believe that some minimal legislative efforts in this area is needed to allow for better oversight at the very least and connect it with the SEC. And, the time to act on that is now. So we will consider that legislative proposal and any others that may be developed.

And, Chairman Shad, we look forward to your continued cooperation in this area.

This session stands in recess.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

[Response to written questions of Senators Cranston, Proxmire, and Dodd follow:]

OFFICE OF
THE COMMISSIONER

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

August 12, 1985

The Honorable William Proxmire
United States Senate
530 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Proxmire:

In Chairman Shad's absence, I am enclosing the attached materials in response to the questions which you submitted for the record in connection with the Commission's authorization hearing on April 17, 1985. Each of your questions is repeated, followed by the response.

Sincerely,

Charles C. Cox

Charles C. Cox
Commissioner

Attachment

cc: Chairman Alfonse M. D'Amato

RESPONSE TO QUESTION OF SENATOR PROXMIRE,

Hearing of April 17, 1985

Question 1. Authorization.

Part a. A number of statements in the budget submissions seem to be at odds with the budget request. For example, with respect to the Supervision and Regulation of Securities Markets, you state that

> "The expanded volume and complexity of the securities trading markets have increased program workload. All market activity indicators are up sharply for the past five years: stock exchange share volume has increased by 228 percent, over-the-counter share volume has risen 450 percent, and exchange option contract volume has grown 224 percent. Complicating this growth are new entrants to the securities services industry, new securities products and the growth of the regulated professional population."

Yet you have reduced the number of staff positions in the Division of Market Regulation from 135 in 1984 to 120 in 1985 and you are content with 120 positions in 1986. Then with respect to the Division of Enforcement, I read that

> "The rapid growth of the securities industry has been accompanied by increases in the indices of potential fraud. However, as complex financial instruments proliferate and markets cross national boundaries, the pursuit and deterrence of fraud becomes increasingly difficult. Consequently, the program must have adequate resources to effectively carry out its responsibilities in a highly technical area of the law."

Yet the resources and staff positions in 1986 for the Division of Enforcement remain the same as in 1985. You are content with what you've got.

And with respect to the Division of Corporation Finance you state that "The projected market growth will trigger increased workload in all areas of the program." But once again, no recommended increases.

How can you make these statements on the one hand and come in to us with a bottom line -- which is essentially a budget freeze -- on the other?

Answer. While the securities industry is increasing in size and complexity, the resource levels contained in the President's budget are both realistic and sufficient for the SEC to discharge its statutory mandate. In 1984, as compared with 1981, the Commission achieved record results in all major program areas with 5% fewer staff. This was achieved through paperwork reduction, automation and other initiatives which enhanced staff productivity. The proposed 1986 budget contains 25 more positions and a $13 million increase in appropriations over 1984 levels. While it may not be possible to continue achieving record results in the coming years, the Commission is confident that, with the resources proposed, it can fully and effectively discharge its mandate in 1986.

Part b. Commissioner Aulana Peters is reported in the February 11, 1985 edition of Wall Street Letter as having "decried the over-all budget freeze, saying it will 'affect our effectiveness to regulate'". I am wondering how you, the Chairman, believe it will affect the Commission's ability to regulate?

Answer. The President's 1986 budget does not propose a freeze for the agency, but rather provides an increase of $885,000. It is true, however, that staff levels will not increase over the 1985-1986 period. Of course, the Commission could do more with more resources. Nevertheless, the staffing proposed for 1986 will permit the Commission to adequately regulate the securities markets and maintain a sound enforcement program.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Question 2. Enforcement.

Part a. Do you believe that the Commission should be granted the authority to fashion monetary relief and impose fines for certain violations?

Answer. For many years the Commission has sought and obtained monetary relief in court actions, in the form of a disgorgement of ill-gotten gains. Also, the Insider Trading Sanctions Act of 1984 (Pub. L. 98-376, Aug. 10, 1984) ("ITSA"), gives the Commission authority to seek court-ordered civil penalties of up to three times the profit gained or loss avoided in unlawful insider trading transactions.

In 1984, the Commission considered the efficacy of its enforcement remedies, including the question of whether it should seek additional administrative authority to impose monetary penalties. Following that consideration, on February 28, 1984, we sent Chairman D'Amato a letter and an accompanying memorandum which concluded that such additional authority should not be sought at that time.

Copies of the February 28, 1984, letter and memorandum are attached.

The memorandum addresses civil money penalties at pages 6 through 8 and concludes:

(1) Other than insider trading, the staff could not identify a serious need for additional remedies to deter specific conduct;

(2) Additional civil penalties might change the character of the Commission's enforcement program. The federal securities laws are presently viewed by the courts as remedial rather than punitive. If amendments authorizing the imposition of civil money penalties were viewed as an expression of Congress' intent to change the character of the enforcement program from remedial to punitive, it might lead the judiciary to be less receptive to Commission injunctive actions. Additional consequences could include judicial determinations that the Commission must prove its cases by clear and convincing evidence, rather than by a preponderance of the evidence, and that enforcement actions must be litigated before a jury. Such developments would complicate enforcement proceedings and lead to the expenditure of additional resources in particular cases;

(3) Money penalties could further complicate settlement of enforcement proceedings, resulting in the need to litigate a larger number of such proceedings, thereby

reducing the number of such proceedings the Commission could undertake;

(4) A final assessment of the net advantage or disadvantage of money penalties should await actual experience with them under the ITSA, which had not yet become law.

The ITSA has been in force for only a year, and at present only two cases brought under its provisions have been concluded. We will continue to consider the question of whether to seek authority to impose additional monetary penalties as the Commission gains further experience under the ITSA.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Enforcement.

Part b. Should repeat offenders be barred from acting as corporate officers or directors?

Answer. In appropriate cases involving individuals who have engaged in egregious violations or demonstrated a pronounced and repeated tendency to ignore the law, the Commission has obtained this type of ancillary relief in the settlement of injunctive actions under the federal securities laws. Judicial orders barring indivduals from corporate offices have been obtained in a least 22 cases since 1975.

RESPONSE THE QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Enforcement.

Part c. Is the Commission's general counsel currently drafting legislation that would ask Congress for extended powers?

Answer. The Commission currently has several legislative proposals before Congress, including amendments to Section 17A of the Securities Exchange Act of 1934 to allow the Commission to impose administrative sanctions on persons associated with transfer agents, introduced as part of H.R. 1604. Also, the Office of the General Counsel is currently assisting the staff of the Vice President's Task Group on Regulation of Financial Services in drafting legislation to implement the Task Group's proposals to amend the securities laws to centralize securities jurisdiction in the Commission.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Enforcement

Part d. "In the section in the budget submission on the 'Prevention and Suppression of Fraud' the SEC indicates that an area of special attention for the Commission will include 'problems arising from growth in the number of small regional broker-dealer firms.'

"What particular problems are you referring to in this area?"

Answer. Several of the Commission's regional offices have reported a substantial growth in the number of small broker-dealer registrants. For example, the number of broker-dealers registered in the Commission's Denver Region more than doubled in the two-year period 1982-84. The Commission's experience is that small newly-registered regional broker-dealers are often under-financed and staffed by under-trained and inadequately supervised personnel.

The combination of substantial growth in the number of small broker-dealer registrants and the problems associated with those registrants creates an environment that requires increased enforcement attention by the Commission and the self-regulatory organizations. Evidence of these requirements was supplied during the fiscal year by: (i) a number of small regional broker-dealers that ceased doing business as a result, primarily, of net capital problems; and (ii) a noted increase in the number of cases involving questionable sales practices by these firms, including "churning" of securities accounts and unauthorized trading.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Enforcement

Part e. "Other areas of special attention you state will include: '(1) efforts by issuers, including publicly-owned banks and bank holding companies, to conceal adverse developments and financial information that is material to investors, (2) violations arising from increased trading of securities in the U.S. through foreign financial institutions, (3) abuses in connection with offerings of securities in oil and gas ventures, (4) problems associated with the market for small issues in the Denver area.'

"Would you describe your concerns in each of these areas a bit more fully for us?"

Answer.

Concealment of adverse developments and material financial information

During the fiscal year, matters observed by the Commission's enforcement staff raised renewed concerns in this area. A number of these matters dealt with troubled, failing or failed publicly traded banks, savings and loans and commercial or industrial finance companies. The Commission continues to note cases where the results of the adverse economic climate that prevailed several years ago were deliberately obscured by issuers in their financial statements.

The Commission recently brought a case that exemplifies certain of its concerns in this area -- In the Matter of Broadview Financial Corporation, Securities Exchange Act of 1934 Release No. 21949, April 17, 1985. A copy of the Commission's "Order Instituting Proceedings Pursuant to Section 15(c)(4) of the Securities Exchange Act of 1934 and Conclusion, Findings and Order of the Commission" in this case is attached as Exhibit A.

Domestic securities trading through foreign financial institutions

Foreign investment in U.S. securities has dramatically increased during the last decade. For example, in 1983 foreign investment in U.S. equities stood at $5.4 billion, 39% greater than the prior year. Gross activity, purchases plus sales, grew 68% to $134.3 billion from $79.9 billion during the same period. Foreign investors accounted for approximately 10.5% of the value of the shares publicly traded on the New York Stock Exchange in 1983.

Based upon the above data, it is indisputable that foreign participation in the U.S. securities market is on the increase. The number of investigations where it is necessary to seek testimony or documents located abroad has, not unexpectedly, increased in proportion to this activity. In this regard, the Commission has initiated two of the largest insider trading cases ever brought which involve trading through Swiss bank accounts, SEC v. Tome (the "St. Joe" case), and SEC v. Certain Unknown Purchasers, et al. (the "Santa Fe" case).

It should also be noted that several foreign jurisdictions have, as a matter of law, prohibited banks and broker-dealers from disclosing information regarding banking and securities transactions to the U.S. While the Commission has been successful in obtaining evidence from these jurisdictions, such assistance has been available in only the most extraordinary cases. As a result, as access to the U.S. market from abroad is enhanced, investors attempting to reduce the chances of having their identities become known during a Commission investigation have begun to invest from these jurisdictions.

Oil and gas securities offerings

Several of the Commission's regional offices noted a proliferation of unregistered offerings in the oil and gas area during the fiscal year. This is a matter of special concern to the Commission's enforcement efforts because of the abuses that historically have occurred in connection with these offerings. A recent typical case that provides examples of these abuses is SEC v. First Oil and Gas Company, Civil Action No. 85-1370-H (C.D. Cal.).

The Commission's complaint also alleged that the defendants raised approximately $2.5 million from at least 400 investors throughout the United States in violation of the securities and broker-dealer registration and anti-fraud provisions of the Securities Act of 1933 and Securities Exchange Act of 1934.

Denver small issue market

Historically, the Denver Regional over-the-counter market has been characterized by the large number of small regulated entities, including broker-dealers and transfer agents, which are under-financed and staffed by under-trained and poorly supervised personnel. Many of these firms specialize in the marketing and transferring of so-called "penny stocks" and securities of small start-up companies with little or no business or earnings history. In this environment, the opportunity for abuses is substantial and the need for a Commission enforcement presence concomitantly high.

The Commission's concerns in this area are closely connected with the substantial growth in small, newly-registered regional broker-dealers. See response to Part d. above.

In recent fiscal periods, the need to devote increased enforcement resources to the problems arising from the Denver Region "Hot Issue" market has been reduced due to the lower level of activity of that market. The Denver Regional over-the-counter market now appears, however, to be positioning itself for a possible resurgence of activity. This appearance is supported both by the number of newly-registered broker-dealers in the region and the number of registrations of securities filed in the region.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

6-6

February 28, 1984

The Honorable Alfonse M. D'Amato
Chairman
Subcommittee on Securities
Room SD-534
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman D'Amato:

As a result of a recent review, the Commission is recommending legislation to close certain "loopholes" and reduce the costs of enforcing the securities laws. This is to request that the Senate Subcommittee on Securities consider the following recommendations:

Summary

The Commission is proposing legislation to:

(1) amend Section 15(c)(4) of the Securities Exchange Act of 1934 to authorize the Commission to commence administrative proceedings

(a) to require compliance with Section 14 of the Act; and

(b) to require the individuals who cause issuers or others to violate Sections 12, 13, 14, or 15(d) of the Act to effect compliance;

(2) amend Section 17A(c)(3)(A) of the Act to authorize the Commission to impose administrative sanctions on persons associated with transfer agents; and

(3) amend Section 24 of the Act to

(a) exempt from the Freedom of Information Act records submitted to the Commission in investigations; and

(b) provide that submission of information to the Commission does not waive the attorney-client privilege, or any other applicable evidentiary privilege, and that such information is exempt from the FOIA.

Discussion

A. Section 15(c)(4)

As described in Attachment A, the Commission recommends an expansion of its authority under Section 15(c)(4) of the Act, which currently authorizes the Commission to institute administrative proceedings against any person subject to Sections 12, 13 or 15(d) of the Act, or the rules promulgated thereunder, who has failed to comply with such a provision in any material respect. This amendment would expand Section 15(c)(4) to encompass violations of Section 14 of the Act and the rules promulgated thereunder. It is consistent with Section 4 of H.R. 559, which passed the House on September 15, 1983. However, the Commission also recommends a further amendment to clarify its authority to name, as respondents in proceedings instituted under Section 15(c)(4), individuals who cause failures to comply with Sections 12, 13, 14 or 15(d) of the Exchange Act, or of the rules promulgated thereunder. A draft bill is attached.

B. Section 17A

The Commission also recommends amendments to Section 17A of the Act that would provide the Commission and federal bank regulatory agencies with administrative authority to sanction persons associated with registered transfer agents. Unlike the Commission's authority respecting registered broker-dealers, the Commission currently is unable to sanction officers and non-clerical employees of transfer agents. While the Commission can revoke a transfer agent's registration for violating the provisions of Sections 17 or 17A, it cannot prevent those individuals actually responsible for the violations from reorganizing their business in a new entity and repeating the violation.

The Commission is currently consulting with the bank regulatory agencies in order to formulate suitable language to correct this deficiency. Those agencies have substantial regulatory responsibility for bank transfer agents, and any amendments to the Act would affect the exercise of their authority. Among other matters, those consultations include the appropriate definition of the term "associated person of a transfer agent" and the appropriate scope and operation of any statutory disqualification. Following the consultation process, we will forward proposed statutory language to you.

C. Section 24

As described in Attachments B and C, the Commission is recommending two amendments to the Act to facilitate compliance with Commission requests for information in the course of its regulatory and enforcement activities under the securities laws. The first (Attachment B) would exempt records disclosed to the Commission in the course of a legitimate law enforcement inquiry from the applicability of the FOIA. The second (Attachment C) would provide that persons supplying information to the Commission in the course of its administration of the securities laws would not thereby waive any evidentiary privileges applicable to the information, including the attorney-client privilege.

These proposals would protect legitimate business and confidential information from being disclosed to competitors of persons supplying the information, to their opponents in litigation, or to others. The amendment would also allow the Commission to devote more of its resources to securities law enforcement, rather than FOIA and confidential treatment requests involving documents obtained in the cause of law enforcement inquiries and to subpoena enforcement and protective order judicial proceedings. Attachments B and C include proposed statutory language. Because certain aspects of these two last proposals may merit further discussion, the Commission suggests that you not introduce them until our staff has had an opportunity to consult with your staff.

* * *

The foregoing and the attachments reflect the views of the Commission and do not necessarily represent the views of the President. This material is being submitted simultaneously to the Office of Management and Budget. We will inform you of any advice received from OMB concerning the relationship of the Commission's views to the program of the Administration.

Please let me know if the Commission can be of further assistance in this matter.

Sincerely,

John S.R. Shad
Chairman

cc: Mr. James L. Frey
Office of Management and Budget

ATTACHMENT A

RESULTS OF THE REVIEW OF THE ADEQUACY OF ENFORCEMENT REMEDIES AND SANCTIONS

The review of the adequacy of santions and remedies has considered the relative costs and benefits of seeking the authority to obtain or impose: (a) broader administrative orders under Section 15(c)(4) of the Securities Exchange Act; (b) administrative cease and desist orders; and (c) civil money penalties. This memorandum summarizes the results of the review.

I. Expansion of the Commission's Authority Under Section 15(c)(4) of the Securities Exchange Act

Section 15(c)(4) of the Securities Exchange Act authorizes the Commission, *inter alia*, to institute administrative proceedings against any person subject to the provisions of Sections 12, 13, or 15(d) of the Securities Exchange Act, or any rule or regulation promulgated thereunder, who fails to comply in any material respect with such provisions. Section 15(c)(4) also authorizes the Commission, upon finding a violation of a statutory provision or rule, to "publish its findings and issue an order requiring . . . [the respondent] to comply with such provision or such rule or regulation thereunder upon such terms and conditions and within such time as the Commission may specify. . . ."

The Commission's authority under Section 15(c)(4) has been used in the past primarily as a means of compelling issuers to correct false or inaccurate periodic reports. It is limited to conduct that violates the requirements of Sections 12, 13, or 15(d) of the Securities Exchange Act, or any rule or regulation thereunder, "in any material respect."

A. Expansion of Section 15(c)(4) to Encompass Persons Subject to Section 14, or the Rules Promulgated Thereunder, Who Violate Such Provisions in Any Material Respect

A major shortcoming of the Commission's existing authority under Section 15(c)(4) is the fact that the Commission may order compliance only with the provisions contained in Sections 12, 13 and 15(d) of the Securities Exchange Act. Violations of Section 14 of the Act, which contains a number of important disclosure provisions, are not included within the Commission's existing authority under Section 15(c)(4).

This dichotomy may result in an uneven enforcement. While the Commission may institute an administrative proceeding to require correction of an annual report which does not contain adequate disclosure of certain material information, it may not take such action with respect to proxy materials that contain the very same deficiencies.

Another shortcoming exists with respect to cases involving violations of the Williams Act, which added Sections 13(d) and 14(d) to the Securities Exchange Act in 1968. Section 13(d) requires the disclosure of certain information relating to beneficial ownership, while Section 14(d) requires disclosure of similar information relating to a tender offer. If a person acquires more than 5 per cent of the stock of a reporting company, files a Schedule 13D and thereafter commences a tender offer, the Commission could take action under Section 15(c)(4) with respect to deficiencies in the bidder's initial filing on Schedule 13D, but it could not proceed against identical deficiencies contained in subsequent filings made pursuant to Section 14 on Schedule 14D-1. Another anomaly lies in the fact that the Commission could institute an administrative proceeding with respect to deficiencies in the initial filing made by the bidder, but could not take action with respect to any deficiencies in a target company's filings in connection with the contest for control, because these filings would be made pursuant to Section 14(d) on Schedule 14D-9. An amendment to Section 15(c)(4) to encompass violations of Section 14 would eliminate these anomalies.

Under these circumstances, the Commission recommends that Section 15(c)(4) of the Securities Exchange Act be amended to authorize the institution of administrative proceedings against persons subject to Section 14 of the Act who fail to comply with that Section, or the rules thereunder, in any material respect. This recommendation is consistent with the amendment to Section 15(c)(4) contained in Section 4 of the Insider Trading Sanctions Act, which was passed by the House on September 15, 1983.

B. Expansion of Section 15(c)(4) to Authorize the Commission to Name Individuals Who Cause Violations as Respondents

Section 15(c)(4) authorizes the Commission to publish its findings and issue an order with respect to any person subject to Sections 12, 13, 14 or 15(d) of the Securities Exchange Act, or the rules or regulations thereunder, who has failed to comply with such section, rule or regulation "in any material respect." The attached legislative proposal, which the Commission recommends and supports, also would clarify the Commission's authority to name individuals as respondents if it appears that they have caused a failure to comply on the part of a subject person. If the Commission should find that an individual was "a cause of the failure to comply," the legislation would authorize the Commission to issue an order directing the individual "to comply, or take steps to effect compliance."

An individual could be found to be "a cause" if he or she engaged in an act, or failed to act, under circumstances where the individual knew or should have known that such act or omission would contribute to a failure to comply. This test would establish two limitations on the scope of individual liability. First, there would have to be a nexus between an individual's act or omission and a particular failure to comply. Second, an individual would be culpable only when he or she knew or should have known that the act or omission would contribute to such failure to comply.

This approach would allow the Commission to proceed against officers or directors or other individuals who cause a failure to comply with Sections 12, 13, 14 or 15(d), or the rules promulgated thereunder, whether or not they fall within the definition of a "controlling person" under Section 20 of the Securities Exchange Act. This would include, for example, the officer who, while not directly participating in the preparation of a report, is responsible for the underlying transaction which required that the report be filed and for providing relevant information to those who do prepare the report. For example, should an officer either provide materially false and misleading information or fail to correct materially false and misleading information, where he knew or should have known of its falsity, the Commission could proceed under Section 15(c)(4) to redress a violation of the reporting requirements. In addition, the officer who prepares or assists in the preparation of materially false or misleading disclosure documents, when he knew or should have known they were false, could be made the subject of a Section 15(c)(4) proceeding. The Commission also would be authorized to direct such a person to take steps necessary to effect compliance on the part of the issuer involved.

The legislation would clarify the Commission's authority to proceed against individuals in a Section 15(c)(4) proceeding. It would eliminate the potential bifurcation of proceedings inherent in the cases where a Section 15(c)(4) proceeding provides an appropriate forum for dealing with violations on the part of an issuer, and it also is appropriate to take enforcement action against the individuals responsible for that violation.

II. Cease and Desist Authority

Cease and desist authority would permit the Commission to issue an administrative order, once a violation is found, that directs a person to refrain, or cease and desist, from engaging in violative conduct. It has been suggested that such a remedy would have a number of advantages, including:

1. Increased flexibility in tailoring remedies to the circumstances of a case;
2. Elimination of gaps in the Commission's administrative authority;
3. Establishment of a remedy for violative conduct that might otherwise escape redress; and
4. Greater ability to fashion relief that would avoid the collateral consequences associated with an injunction, such as the statutory disqualification from serving as an officer or director of an investment company.

Although a cease and desist proceeding would, in most cases, provide a milder remedy than a civil injunctive action, it could provide increased deterrence in those cases where the Commission does not have sufficient evidence to demonstrate a reasonable likelihood of future violations. A cease and desist remedy also could serve to promote greater flexibility in fashioning remedies in cases where the collateral effects of an injunction may be inappropriate. In addition, such a remedy would improve the ability of the public to distinguish degrees of culpability. However, these benefits are, at best, marginal.

It is important to understand that most of the agencies that have cease and desist authority are not authorized to seek federal court injunctions to stop and prevent violations of the law. The Commission already has enforcement tools that provide relief similar to cease and desist orders through court procedures that are more efficient and less cumbersome than on the record proceedings under the Administrative Procedure Act. In addition, the availability of a cease and desist remedy might make the courts more reluctant to grant favorable consideration to the Commission in civil injunctive actions, particularly if defendants contend that a cease and desist order is a more appropriate remedy in the context of a given case.

One of the more serious objections to a cease and desist remedy lies in the difficulty in articulating a program-based need for such a remedy. While cease and desist authority might provide flexibility in dealing with particular cases, a legislative proposal could not be justified on the grounds that existing remedies are inadequate to stop and deter particular types of conduct. This, of course, is the principal rationale for the proposed Insider Trading Sanctions Act. In addition, there are no anomalies in the existing statutory scheme, similar to those that exist with respect to Section 15(c)(4), which would warrant such an amendment. Moreover, to the extent the Commission might be expected to use cease and desist authority to pursue cases where it does not have sufficient evidence to demonstrate a reasonable likelihood of future violations, or cases that otherwise do not warrant the filing of a complaint in a district court, there is a serious question whether the Commission should spend its enforcement resources in pursuit of such cases.

The enactment of the amendments to Section 15(c)(4) that the Commission is recommending would provide the Commission with additional flexibility in dealing with those cases where cease and desist authority might be most useful. Because the proposed amendments to Section 15(c)(4) would provide the Commission with adequate administrative authority to deal with false, misleading or delinquent periodic reports, proxy materials and beneficial ownership reports, the potential benefits of a separate proposal for cease and desist authority appear extremely marginal.

While it is difficult to articulate a need for cease and desist authority, there are a number of disadvantages inherent in seeking such authority. To the extent a cease and desist remedy might be used in cases that would otherwise merit a civil injunctive action, there might be a perception that the remedy inappropriately serves to accommodate the interests of those who break the law. Such a perception could undermine the ability of the enforcement program to deter violations of the federal securities laws. In addition, the availability of a cease and desist remedy could inhibit the Commission's ability to settle enforcement actions. Potential subjects of enforcement proceedings could be expected to hold out for settlements based on a cease and desist order rather than an injunction because the former remedy is viewed as more mild and would not entail the collateral consequences of an injunction.

From a resource perspective, if a cease and desist order should be violated, the Commission would be forced to seek a court order commanding compliance with the Commission's order, and the court order would have to be violated, before contempt proceedings could be initiated. This might result in less effective use of enforcement resources.

Finally, there are pragmatic considerations. A Commission recommendation of legislation providing cease and desist authority might complicate the chances for early enactment of the Insider Trading Sanctions Act. In addition, unlike the proposed amendments to Section 15(c)(4), which are technical in nature, there is a possibility that a legislative proposal with respect to cease and desist authority could be controversial. Under these circumstances, and for the reasons set forth above, the Commission determined that it would not be prudent to seek the enactment of legislation that would provide an administrative cease and desist remedy.

III. Civil Money Penalties

There are many different types of civil penalties and differing purposes for which they can be established. Accordingly, depending on the purpose and rationale adopted, there is a broad range of potential legislative proposals that could be drafted. One rationale, which is reflected in the Commission's recommendation of the Insider Trading Sanctions Act, is increased deterrence. However, civil penalties of relatively small amounts could be used to mitigate the potential harshness of license revocations or suspensions.

A civil money penalty may be imposed, depending on the statute involved, by either a court or an administrative agency. The vast majority of existing civil money penalty provisions provide relatively small penalties for common and repetitive offenses. It is doubtful, however, whether this type of civil penalty would be cost-effective. The Commission's enforcement resources should be used in a manner that will maximize the deterrent effect of its investigations and the enforcement actions.

Civil money penalties could be helpful in a number of respects. Money penalties of sufficient magnitude could raise the level of risk for those who violate the federal securities laws and thereby serve to deter future violations. In addition, to the extent a civil money penalty might be assessed in light of the gravity of an offense, it would facilitate the tailoring of enforcement remedies to the circumstances of a particular case. For the same reason, the imposition of a civil penalty could enhance the ability of the public to distinguish between the gravity of different violations of the federal securities laws. At the present time, the relief obtained in the Commission's civil injunctive actions is generally an injunction against further violations and the disgorgement of illicit profits, with no distinction in the type of remedy to reflect the seriousness of the offense.

However, unlike the Insider Trading Sanctions Act, which was specifically designed to deal with problems the Commission has encountered in the context of insider trading cases, the Commission has been unable to identify a serious need for additional remedies to deter a specific type of conduct. The Commission believes that its existing remedies are effective in most cases. In addition, where circumstances warrant, a case can be referred to the Justice Department for criminal prosecution.

Under these circumstances, the advantages of seeking additional civil penalties appear to be marginal. Moreover, these marginal benefits must be balanced against a number of potentially serious disadvantages.

A major concern is the possibility that additional civil penalties might change the character of the Commission's enforcement program. The federal securities laws are presently viewed by the courts as remedial rather than punitive. If amendments authorizing the imposition of civil money penalties should be considered as an expression of Congress' intent to change the character of the enforcement program from remedial to punitive, it might lead the judiciary to be less receptive to Commission injunctive actions. Additional consequences could include judicial determinations that the Commission must prove its cases by clear and convincing evidence, rather than preponderance of the evidence, and that enforcement actions must be litigated before a jury. Such developments would certainly complicate enforcement proceedings and lead to the expenditure of additional resources in particular cases.

Another serious reservation with respect to additional civil penalties is their potential impact upon the Commission's ability to settle enforcement actions. The ability to settle cases, and obtain remedial relief to protect the investing

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public without litigating the allegations set forth in a complaint or Order for Proceedings, is an important part of the Commission's enforcement program. More than 90% of the Commission's enforcement actions are settled by the defendants or respondents involved, generally without admitting or denying the Commission's allegations. The Commission could not maintain a strong enforcement presence if it had to litigate a large portion of its enforcement actions.

While a statute authorizing large civil money penalties could influence some defendants to settle cases for a lesser amount, rather than face greater penalties after litigation, such penalties could also make it more likely that defendants or respondents would litigate enforcement actions. There could be protracted discussions during settlement negotiations with respect to the dollar amount of a potential settlement. In addition, the potential for resource-intensive litigation could be greatly increased if the availability of a civil penalty should have the effect of making it difficult for the Commission to settle an enforcement action for a penalty that is substantially less than the maximum amount allowable. This might occur if the Commission is criticized for failure to make maximum use of available enforcement remedies.

Under these circumstances, the Commission determined that the more prudent course is to refrain from seeking any civil penalties in addition to those sought in the Insider Trading Sanctions Act, which is pending before the Congress. While the concept of civil penalties may have some surface appeal, there are a number of potential disadvantages that could have serious consequences for the enforcement program. Moreover, it is difficult to assess the potential impact of these consequences in light of the information presently available. Under these circumstances, it would be desirable to await enactment of the Insider Trading Sanctions Act, and gain some experience in utilizing civil penalties in the context of insider trading cases, before giving further consideration to the relative merits of additional civil money penalties. This approach will also avoid the possibility that a recommendation of additional civil penalties would slow the Congress' consideration of the Insider Trading Sanctions Act, which is needed to deter the trading of securities on the basis of material non-public information.

A BILL

To amend the Securities Exchange Act of 1934 to permit administrative remedies for violations of Section 14 of that Act.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. That Section 15(c)(4) of the Securities Exchange Act of 1934 is amended to read:

"If the Commission finds, after notice and opportunity for hearing, that any person subject to the provisions of section 12, 13, 14, or subsection (d) of section 15 of this title or any rule or regulation thereunder has failed to comply with any such provision, rule, or regulation in any material respect, the Commission may publish its findings and issue an order requiring such person, and any person who was a cause of the failure to comply due to an act or omission the person knew or should have known would contribute to the failure to comply, to comply, or take steps to effect compliance, with such provision or such rule or regulation thereunder upon such terms and conditions and within such time as the Commission may specify in such order."

ATTACHMENT B

STATEMENT OF THE SECURITIES AND EXCHANGE COMMISSION IN SUPPORT OF A PROPOSED AMENDMENT TO SECTION 24 OF THE SECURITIES EXCHANGE ACT OF 1934 TO EXEMPT CERTAIN RECORDS FROM DISCLOSURE UNDER THE FREEDOM OF INFORMATION ACT

Introduction

The Securities and Exchange Commission recommends that Section 24 of the Securities Exchange Act of 1934 be amended to exempt from disclosure under the Freedom of Information Act ("FOIA") certain records prepared by private individuals and entities in the ordinary course of their business which come into the Commission's possession as a result of its law enforcement inquiries. [1] The proposed amendment would add a new subsection (c) to read:

> "(c) Records in the Commission's possession shall be exempt from disclosure under Section 552 of Title 5, United States Code if they were provided to the Commission (1) pursuant to compulsory Commission process or voluntarily in any investigation or inspection permitted by the securities laws, or the rules and regulations adopted under such laws, or (2) otherwise in response to a Commission request preceded or accompanied by a certification that the request is made in connection with a law enforcement inquiry."

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[1] The Commission has previously recommended a similar amendment. See *Business Accounting and Foreign Trade Simplification Act: Joint Hearings on S. 708 to Amend and Clarify the Foreign Corrupt Practices Act of 1977 Before the Subcomm. on Securities and the Subcomm. on International Finance and Monetary Policy of the Senate Committee on Banking, Housing and Urban Affairs*, 97th Cong., 1st Sess. 281, 308-311 (1981) (written statement of John S.R. Shad, Chairman, Securities and Exchange Commission).

The term "law enforcement inquiry," used in the proposal, is defined in Section 1101(7) of the Right to Financial Privacy Act to mean "a lawful investigation or official proceeding inquiring into a violation of, or failure to comply with, any criminal or civil statute or any regulation, rule or order issued pursuant thereto." We would expect the term to be interpreted similarly under Section 24(c).

In the course of carrying out its responsibilities to enforce the federal securities laws, the Commission receives a great deal of information from or concerning those under investigation. 2/ Much of that information is not required to be filed with the Commission and is not publicly available from the companies or individuals involved. And, in many instances, these documents have limited circulation, even within the submitting organizations. Items such as corporate financial plans, minutes, internal correspondence, and stockholder lists generally are not available to members of the public. Those who submit information during an investigation are rightfully concerned that its presence in Commission files not result in unnecessary public disclosure of such information. In addition, heightened concern that the submission of the information to the Commission will ultimately result in disclosure is adversely affecting the Commission's ability to investigate possible violations of the federal

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2/ Section 21(g) of the Securities Exchange Act defines the term "securities laws" to include the Securities Act of 1933 (15 U.S.C. 77 et seq.), the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), the Public Utility Holding Company Act of 1934 (15 U.S.C. 79a et seq.), the Trust Indenture Act of 1939 (15 U.S.C. 77aaa et seq.), the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.) and the Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa et seq.).

securities laws, because companies that are the subject of an investigation are more likely to resist requests for such information and documents rather than comply on a voluntary basis. The proposed amendment would address these problems.

Discussion

Under the FOIA, unless some exemption is available, information contained in "agency records" must be released upon request by a member of the public. [3] During the active phase of Commission law enforcement efforts, the Commission can and generally does successfully assert Exemption 7(A) to withhold investigatory records, *see*, *e.g.*, *King v. Securities and Exchange Commission*, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶98,428 (E.D. Pa. Jan. 4, 1982); *OKC Corp. v. Williams*, 489 F. Supp. 576 (N.D. Tex. 1980), *modified on rehearing*, CA-3-78-1021-G (N.D. Tex. June 9, 1980) (Order on Motions for Reconsideration); and *Rosenberg v. Securities and Exchange Commission*, [1979] Fed. Sec. L. Rep. (CCH) ¶96,825 at 95,303 (D.D.C. Apr. 4, 1979). When no active investigation is pending, and other law enforcement efforts have been concluded, however, Exemption 7(A) 4/ is unavailable, see Pacific Molasses Co. v. N.L.R.B., 577 F.2d 1172 (5th Cir. 1978), and other exemptions must be relied upon if documents, including items received from third parties, are to be protected from general public scrutiny.

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[3] There is some uncertainty concerning what constitutes "agency records" under the FOIA, which does not define the term. *See* *Kissinger v. Reporters Committee for Freedom of the Press*, 445 U.S. 136 (1980); *McGehee v. CIA*, 697 F.2d 1095 (D.C. Cir. 1983), *vacated in part on panel reh'g, reh'g en banc denied*, 711 F.2d 1076 (D.C. Cir. 1983) (per curiam).

Persons requesting access to information in the Commission's investigatory files include business competitors of the submitter of the information or persons engaged in litigation against the submitter. These requesters seek the information as a means of discovering confidential information which may secure them some advantage over the submitter of the information, a result that was clearly not contemplated by Congress when it enacted the FOIA or by the Commission when it commenced its investigation. After the government's law-enforcement interest in a matter is concluded, the Commission is essentially a stakeholder in disputes concerning release of this information.

The exemption most often relied upon in such situations is Exemption 4, which protects "trade secrets and commercial or financial information obtained from a person and privileged or confidential." Yet, it is clear from the language of Exemption 4 and from judicial decisions interpreting it, that it is of limited applicability and will generally only protect information the release of which would cause "substantial

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4/ Exemption 7(A) protects records from disclosure where disclosure would "interfere with enforcement proceedings."

competitive harm" to the person from whom it is obtained. 5/ Thus, a submitter does not know at the time of submission whether the information will later be disclosed under the FOIA. The proposed amendment would remove this uncertainty because it would operate as a specific withholding statute under Exemption 3 of the FOIA. 6/

Given the present state of the law, many persons who are requested to submit information during Commission law enforcement investigations perceive a risk that information ultimately may become public under the FOIA. Because of this perception, there is often substantial resistance to the voluntary and prompt submission of confidential information to the Commission.

Voluntary submission of information is critical to the success of the Commission's enforcement program. The

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5/ See generally Board of Trade of the City of Chicago v. Commodity Futures Trading Commission, 627 F.2d 392 (D.C. Cir. 1980); National Parks and Conservation Association v. Morton, 498 F.2d 765 (D.C. Cir. 1974).

6/ Exemption 3 provides that the FOIA does not apply to records that are:

> specifically exempted from disclosure by statute (other than section 552b of this title), provided that such statute (A) requires that the matters be withheld from the public in such a manner as to leave no discretion on the issue, or (B) establishes particular criteria for withholding or refers to particular types of matters to be withheld."

5 U.S.C. 552(b)(3).

Commission needs access to such information in order to make informed decisions in executing the various laws the Commission is charged with administering. Information can be secured on a more timely and less expensive basis through voluntary cooperation. In addition, prompt completion of investigations makes enforcement actions more timely and more effective. On the other hand, resistance that forces the Commission to seek judicial enforcement of a subpoena can consume years of effort and the delay involved may dilute the Commission's equity for injunctive relief when the process is completed.

The elimination of the possibility of unwarranted disclosure of confidential documents after an investigation is completed would make companies more willing to supply information requested during an investigation, and reduce the need for the use of subpoena power or subpoena enforcement actions to compel compliance with a subpoena. The use of such compulsory measures adds to the demands made upon the Commission's staff and resources.

In addition, a significant amount of professional time is currently spent reviewing requests for confidential information after an investigation is completed. This is in addition to time that must be devoted to processing confidential treatment requests routinely filed by submitters. With this amendment, the Commission could redirect this professional time and effort to assure the most efficient and productive use of its enforcement staff.

The Commission estimates that the proposed amendment would result in a direct savings of over 25,000 staff hours each year. This includes a substantial amount of time expended by senior members of the Commission's staff at the GS-14 level or above; these persons are compensated at rates in excess of $40,000 per year.

The indirect savings, although difficult to quantify with precision, would be even greater. These indirect costs now include staff hours spent in negotiating and litigating FOIA requests and reviewing FOIA appeals. All of this time, now spent reviewing files of closed investigations in response to FOIA requests, could be put to more effective use. Of course, substantial savings would also accrue to private parties who submit information to the Commission in the course of investigations. 7/

7/ In 1980, Congress granted an exemption similar to the present Commission proposal to another law enforcement agency, the Federal Trade Commission, for similar reasons. 15 U.S.C. 57b-2(f), Pub. L. 96-252 (May 28, 1980). As Senator Ford said during the floor debate on this provision,

> "* * * the main purposes of the exemption are to protect proprietary data without affecting agency accountability to the public through the FOIA and to encourage compliance with legitimate information demands * * *." Congressional Record, May 21, 1980, p. S5678.

Conclusion

Accordingly, the Commission recommends that Section 24 of the Securities Exchange Act be amended to exempt from disclosure under the FOIA certain third-party records which come into the Commission's possession during a legitimate law enforcement inquiry. Also, Section 21(g) of the Securities Exchange Act should be amended to include a reference to new Section 24(c) in the definition of "securities laws". Because these revisions relate only to Sections 24 and 21(g) of the Securities Exchange Act and the definition of records and securities laws contained therein, it would not effect a change in the FOIA itself or in the information disclosure practices of any other federal agency.

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ATTACHMENT C

SECURITIES AND EXCHANGE COMMISSION STATEMENT IN SUPPORT OF PROPOSED SECTION 24(d) OF THE SECURITIES EXCHANGE ACT OF 1934

I. Summary

Proposed new Section 24(d) of the Securities Exchange Act of 1934 is intended to resolve the uncertainty about the status of certain information, to which a claim of attorney-client privilege or coverage of the work-product doctrine may be applicable, that is obtained by the Commission. The new provision would protect persons in possession of such information from claims that disclosure to the Commission waived the privilege, and permit the Commission to withhold such information from disclosure.

II. Discussion

Frequently, documents and information are turned over to the Commission, either voluntarily or under legal process, for official use. In most cases, it is irrelevant, as far as the Commission is concerned, that private parties in litigation against the supplier of the information could not obtain such information because of the existence of the attorney-client or other privilege or the work-product doctrine. 1/ The Commission

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1/ As to corporations, in Upjohn v. United States, 449 U.S. 383 (1981), the Supreme Court held that a corporation can claim the attorney-client privilege only for communications that are:

(footnote continued)

uses the information for official purposes without regard to any claim of privilege.

In some cases, the Commission does not make the information public because the information is found to be unnecessary to supplement other public disclosures made in filings with the Commission or otherwise, or to support a Commission enforcement action, because no action is brought, or for other reasons.

1/ (continued footnote)

> (1) made by corporate employees; (2) directed to corporate counsel acting as such; (3) made at the direction of corporate superiors; (4) necessary in order to secure legal advice; (5) about matters within the scope of the employees' corporate duties; (6) made by the employees who were aware they were being questioned so that the corporation could obtain legal advice; and (7) considered confidential when made and kept confidential by the company. 449 U.S. at 394-5.

The work-product doctrine is essentially stated as follows in Rule 26(b)(3) of the Federal Rules of Civil Procedure:

> [a] party may obtain discovery of documents and tangible things otherwise discoverable * * * and prepared in anticipation of litigation or for trial by or for another party or by or for that other party's representative (including his attorney, consultant, surety, indemnitor, insurer, or agent) only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of his case and that he is unable without undue hardship to obtain the substantial equivalent of the materials by other means. In ordering discovery of such materials when the required showing has been made, the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation.

(codifiying Hickman v. Taylor, 329 U.S. 495 (1947)).

A. Attorney-Client and other Privileges

There is some uncertainty whether disclosure to the Commission waives the attorney-client or other privileges. Some federal courts have regarded such disclosure as a "general waiver," while others have construed similar disclosure of privileged material to the Commission as a "limited waiver." 2/ The proposed legislation would remove this uncertainty by providing that disclosure of privileged information to the Commission does not waive a privilege, or is only a "limited waiver", when third persons are seeking that information from the supplier of the information. Thus, an issuer that has attorney-client communications could surrender those materials to the Commission to assist it in its law enforcement responsibilities to determine whether there had been full and adequate disclosure, and the surrendering issuer would not be making a general waiver of the attorney-client privilege but only a "limited waiver."

The possibility that disclosure to the Commission acts as a general waiver of the attorney-client privilege or other privileges

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2/ Compare Upjohn Co. v. United States, 449 U.S. 383 (1981) (generic disclosure to Commission of internal company investigation did not waive privilege as to background documentation) and Diversified Industries, Inc. v. Meredith, 572 F.2d 596, 611 (8th Cir. 1978) (en banc) (voluntary disclosure of documents subject to attorney-client privilege to a governmental agency constitutes only a limited waiver of the privilege with respect to that agency), with Permian Corporation v. United States, 655 F.2d 1214, 1219-20 (D.C. Cir. 1980) (any voluntary disclosure by holder of attorney-client privilege waives the privilege entirely), and In re Sealed Case, [Current] Fed. Sec. L. Rep. (CCH) ¶ 98647 (D.C. Cir. April 23, 1982) (voluntary disclosure effects waiver beyond material actually disclosed, and extends to materials necessary for a fair evaluation of disclosures).

impedes the Commission's enforcement efforts because it results in less voluntary compliance with Commission requests for information, and may tend to cause legal challenges to Commission subpoenas for such information. Furthermore, frequently issuers make proper assertions of the attorney-client privilege when refusing to surrender materials to the Commission's enforcement staff, and will not provide the Commission limited access to such materials because of the fear that it would constitute a "general waiver" of the attorney-client privilege. Indeed, because of the Permian and Sealed Case decisions, issuers and their counsel have refused to permit access by the Commission to privileged information when they have otherwise wished to do so.

If a "limited waiver" exception becomes law, it is believed that issuers are likely to selectively waive the attorney-client privilege in order to cooperate in Commission investigations with a desire to expedite and make less expensive investigations of possible violations. This does not occur at the present time because of the uncertainty whether limited access by the Commission to privileged materials constitutes a "limited waiver" or a "general waiver" of the privilege.

As John Fedders, Director of the Division of Enforcement stated in August 1982:

> The Commission is keenly interested in the waiver topic. It has an impact on implementation of the "voluntary disclosure program" which permits a a registrant, subject to the filing and disclosure requirements of the federal securities laws, to disclose previous deficiencies in its filings and correct them without necessarily incurring a full-blown SEC investigation and likely enforcement action * * *.
>
> In order to encourage voluntary corporate compliance, the Commission will give consideration to efforts of companies which promptly correct erroneous or inadvertent disclosure and take other appropriate remedial

action. The Commission's objective is compliance with the law. Obviously, voluntary disclosure will not be a self-immunizing process. The Commission has always taken into consideration voluntary disclosure efforts in formulating its enforcement determinations. Such considerations will continue. Of course, the nature of certain violations will affect the degree of consideration accorded.

Obviously, when an internal investigation is concluded and corrective disclosure is made, the Commission will wish to be satisfied that the emendatory filing is accurate and complete. The enforcement staff will require disclosure to it of information underlying the internal investigation. Certain of this material is often otherwise protected by the attorney-client privilege and work product rule. Thus, we have the issue whether and to what extent cooperation with the Commission's staff may result in a waiver of the privilege or the work product protections otherwise applicable in subsequent litigation involving private parties or other government agencies.

Because there is no certainty here, some corporations have been reluctant to participate in a voluntary disclosure program. They consider it "unseemly" and "infelicitous" for a corporation to (i) volunteer or produce otherwise privileged materials to the Commission; (ii) have that privilege waived; and (iii) then have the materials available to the government agencies and private litigants as a weapon against the corporation. The dilemma is real. In addition, while my remarks have concerned the voluntary disclosure program, the same problem arises whether the staff seeks access to information in connection with formal investigation or enforcement action. The desire to preserve the applicability of the privilege and work product claims deters some who might otherwise cooperate with a Commission inquiry. This reluctance on their part makes the Commission staff's job more difficult.

* * *

By reason of the differing views of the courts that have addressed the "general waiver" versus "limited waiver" theories, a corporation seeking to participate in a voluntary program discloses privileged materials to the staff without certainty as to waiver of privilege protections and at its

> peril. Consequently, the split in decision has resulted in the enforcement staff being called upon to consider protective orders, stipulations, or other expressed reservations of a producing party's claim of privilege as to materials to be produced. A resolution of the waiver theory is important (i) for public policy purposes; (ii) in order to effectively utilize the Commission's limited resources; (iii) in order to encourage participation in the Commission's voluntary disclosure program to correct past disclosure deficiencies for the benefit of investors and permit the staff to verify the accuracy of such corrections, and (iv) to further encourage parties to cooperate with the enforcement staff in connection with informal and formal Commission investigations. 3/

B. Work Product Doctrine

There is a similar problem with respect to the work-product doctrine. Disclosure to the Commission does not necessarily destroy work-product immunity, since the primary purpose of that immunity is not so much the protection of the confidentiality of the information, but rather the integrity of the adversarial system. Hickman v. Taylor, 329 U.S. 495 (1947); United States v. AT&T, 642 F.2d 1285, 1298-1300 (D.C. Cir. 1980). Nonetheless, as discussed below, material protected by the work-product doctrine may not be withholdable by the Commission under the Freedom of Information Act, 5 U.S.C. 552 ("FOIA"), because it may not be "commercial or financial" within the meaning of that Act or otherwise exempt from mandatory disclosure. Thus, the function of the proposed legislation in the work-product area is to make

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3/ Speech before American Bar Association Section on Corporation, Banking and Business Law, August 8, 1982, Legal Times August 16, 1982, pp. 15-16.

area is to make it clear that the Commission is not required to disclose information subject to the work-product doctrine under the FOIA and that persons seeking such information must look elsewhere and be subject to applicable legal principles in doing so. 4/

C. Freedom of Information Act -- Requests to the Commission

The waiver problem usually arises when private parties are attempting to obtain information from other private parties, and the seeker of the information claims that disclosure to the Commission has waived a privilege. Private parties also attempt to obtain such information from the Commission.

In this context, some information covered by the attorney-client privilege and the work-product doctrine is protectable under Exemption 4 of the FOIA (5 U.S.C. 552(b)(4)). That exemption protects from disclosure "trade secrets and commercial or financial information * * * privileged or confidential." But there is some privileged or work-product information that does not meet the statutory requirement of being "commercial or financial." Courts have interpreted this language as requiring that the release of the information must be likely to cause competitive harm. *See*, *e.g.*, *National Parks and Conservation Association v. Morton*, 498 F.2d 765, 767 (D.C. Cir. 1974).

4/ The work product doctrine has been characterized as a privilege. For simplicity of expression, proposed Section 24(d) also refers to it as a privilege.

As is the case with possible waiver of privilege by the supplier of the information, the possibility that the Commission may not legally withhold such information under the FOIA also impedes voluntary disclosure and Commission enforcement efforts. New Section 24(d) resolves the legal uncertainty by exempting such privileged information and information subject to the work-product doctrine from disclosure under the FOIA.

This overlaps to some degree the exemption provided by the Commission's proposal to add a new Section 24(c), which covers information received by the Commission in inspections and investigations. The exemption in Section 24(d) would also apply in such cases and apply as well to information submitted to the Commission other than in the course of an inspection or investigation. But in all such cases, under Section 24(d), in order to be exempt from the FOIA, the information would be required to be subject to a legally-cognizable privilege.

It should be noted, however, that proposed Section 24(d) would not affect the authority of the Commission to make otherwise protected information available to other federal agencies and to state, local, and foreign governments and agencies for legitimate law enforcement purposes.

D. Procedures for Determining Applicability of Privilege

Section 24(d) also sets forth formal procedures for determining the availability of a privilege based in part on the Commission's current regulation for Confidential Treatment Procedures under the Freedom of Information Act, 17 CFR 200.83. The Section provides that if the Commission proposes to disclose information with respect to which a privilege has been asserted, that it give notice to a person asserting the privilege ("affected person") for an initial determination of the status of the information, for an appeal of an adverse initial determination, for notice to the affected person that he or she may seek judicial review of an adverse decision, and for judicial review.

E. Legislative Precedent

There is precedent for legislation such as proposed Section 24(d) in the Antitrust Civil Process Act, 15 U.S.C. 1311 *et seq.*, which specifically provides that, under certain circumstances, the production of privileged material to the Antitrust Division of the Department of Justice will not be deemed to waive applicable privileges. The non-waiver provision, codified at 15 U.S.C. 1312(c)(2), was adopted in 1980 on the grounds that "this provision will make it easier for litigants to assist the Antitrust Division in its investigation of a suspected antitrust violation without fear that they are waiving the privileged status of such materials." H.R. Rep. No. 870, 96th Cong., 1st Sess. 12 (1980), *reprinted in* [1980] U.S. Code Cong. & Admin. News 2716, 2725.

Enactment of the legislation proposed here would serve a similar purpose by expediting the Commission's investigations of possible federal securities laws violations.

If the Commission determined to delegate the initial decision and appeal functions to appropriate staff officials, it could do so under 15 U.S.C. 78d-1 and 78d-2.

F. Conclusion

Congress should enact new Section 24(d) and a conforming amendment to Section 21(g) (both attached) as necessary for the legitimate protection of business information and to enhance the Commission's enforcement program.

New Section 24(d) of Securities Act of 1934

(d)(1) Notwithstanding any other provision of law, the disclosure of any information by any person to the Commission, other than information otherwise required to be publicly dislosed under the securities laws, Commission rule, or court order, shall not constitute a waiver of any legally cognizable privilege, including the work product doctrine, as to any private person, if, at or before the submission to the Commission of such information, any affected person notifies the Commission in writing of a claim of privilege with respect to the information and the basis for such claim. Section 552 of title 5 shall not apply to any such information to which such privilege applies.

(2) The Commission shall not be required to make any determination as to the validity of a claim of privilege until it proposes to disclose the information.

(3) If the Commission has been notified of any claim of privilege in accordance with paragraph (1), it shall not disclose such information to any private person unless:

(A) it has given written notice to the affected person of an intention to make such disclosure, identifying the specific information to be disclosed, and the persons to whom disclosure is to be made, and

(B) the affected person has consented in writing to such disclosure, or the affected person has failed to object in writing within 30 calendar days of the mailing of the notification by the Commission; or

(C) the Commission determines that the claim of privilege is invalid. In such case:

(i) The Commission shall give written notice to the affected person of this determination and of the intention to disclose the information, together with the names of the persons to whom disclosure is to be made.

(ii) Disclosure shall be stayed if, within 15 calendar days of mailing by the Commission of notice of the its decision, the affected person presents a written appeal of the determination to the Commission, setting forth the legal grounds for the claim of privilege upon which the objection to disclosure is based. The Commission shall act upon this appeal under such rules and regulations as it shall promulgate for this purpose.

(iii) The Commission shall decide all such appeals within 30 business days of their receipt, provided that this time may be extended with the consent of the affected person or upon a written certification by the Commission that the time limits for processing an appeal cannot be met without significantly obstructing or impairing the timely performance of a statutory Commission function.

(iv) If the Commission has not received an appeal within the period specified in subparagraph (ii), it may disclose the information at any time after 15 calendar days from the date the Commission has mailed a written notice of the intention to disclose to the affected person.

(v) The Commission shall promptly give written notice of its decision in an appeal to the person appealing and shall specify the grounds of such decision. Within 15 days from the date the Commission has mailed such notice, during which disclosure shall be further stayed, any affected person on whose appeal the Commission has decided adversely may seek judicial review of the Commission's decision in accordance with Section 25(a) of this title.

(4) The term "affected person" as used in this subsection means any person claiming a legal right to assert a privilege.

(5) The Commission may adopt such rules as are necessary or appropriate to implement the provisions of this subsection.

* * *

Amendment to Section 21(g)

The second sentence of Section 21(g) is amended so that the first clause reads "The term 'securties laws' as used herein, in subsection (h) and in subsections (c) and (d) of Section 24 * * *."

AR/81(17)/cj/ab

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

Securities Exchange Act of 1934
Rel. No. 21949 / April 17, 1985

Accounting and Auditing Enforcement
Rel. No. 54 / April 17, 1985

Administrative Proceeding File No. 3-6502

In the Matter of

BROADVIEW FINANCIAL CORPORATION
6000 Rockside Woods Boulevard
Cleveland, Ohio 44131

ORDER INSTITUTING PROCEEDINGS PURSUANT TO SECTION 15(c)(4) OF THE SECURITIES EXCHANGE ACT OF 1934 AND CONCLUSION, FINDINGS AND ORDER OF THE COMMISSION

The Commission deems it appropriate and in the public interest that proceedings pursuant to Section 15(c)(4) of the Securities and Exchange Act of 1934 ("Exchange Act") [15 U.S.C. 78o(c)], be, and they hereby are, instituted with respect to Broadview Financial Corporation ("Broadview") to determine whether Broadview filed with the Commission quarterly reports on Form 10-Q pursuant to Section 13(a) of the Exchange Act, which contained financial statements which materially overstated Broadview's revenues from the sales of real estate. Accordingly,

IT IS ORDERED that public proceedings pursuant to Section 15(c)(4) of the Exchange Act be and they are hereby instituted.

Simultaneously with the institution of these proceedings, Broadview has submitted an Offer of Settlement for purposes of disposing of the issues raised in these proceedings. Under the terms of its Offer of Settlement, Broadview, solely for the purpose of this proceeding and any other proceeding brought by or on behalf of the Commission or in which the Commission is a party, and without in this proceeding admitting or denying any of the Findings or Conclusion set forth herein, consents to the issuance of this Order Instituting Proceedings and Conclusion, Findings and this Order of the Commission and undertakes certain actions.

The Commission has determined that it is appropriate and in the public interest to accept this Offer of Settlement by Broadview and, accordingly, is issuing these Conclusion, Findings and Order ("Order").

I.

FACTS

A. Summary

This administrative proceeding concerns Broadview's overstatement of revenue and net income in the second quarter of 1982 by including in its reported revenues a $4 million fee which Broadview received in connection with the sale of the Sea Level Ranch, an undeveloped tract of land near Stuart, Florida. Broadview provided a loan to finance the purchase of the land and the $4 million came indirectly from the proceeds. Broadview, however, accounted for the transaction as if Broadview was the seller of the executory contract to purchase the land. When attempting to obtain the approval of its then existing auditors ("auditors") for its accounting for the transaction, Broadview failed to disclose to the auditors material information concerning the source of the $4 million paid to Broadview.

Broadview filed its June 30, 1982 quarterly report on Form 10-Q, which accounted for the $4 million as a gain. In October 1982, Broadview's auditors reviewed documents recently provided to them by Broadview which disclosed the details concerning the loan to the purchaser. Thereafter, the auditors informed Broadview that the $4 million gain on the Sea Level Ranch transaction was recorded improperly and that it must be restated. Broadview's management contacted four other "Big Eight" accounting firms until it found one that was willing to allow Broadview, after minor modifications to the transaction, to recognize the $4 million as immediate revenue from the Sea Level Ranch transaction. The three other firms contacted agreed with Broadview's auditors' position on the transaction. Broadview then dismissed its auditors and engaged the firm that would allow it to recognize income from the transaction. As a result of inappropriately recognizing revenue on this transaction, Broadview overstated its revenues and net income in its quarterly reports on Form 10-Q for the quarters which ended on June 30 and September 30, 1982.

The Commission's staff, through its comment process, informed Broadview prior to the filing of its 1982 annual report on Form 10-K that the manner in which it had accounted for the Sea Level Ranch transaction was improper. The staff also informed Broadview that it should restate those previous filings reporting the $4 million gain. In March 1983, Broadview restated its reported earnings from the Sea Level Ranch transaction.

B. Respondent

Broadview, an Ohio corporation, was incorporated on November 20, 1972, as a savings and loan holding company. Its principal asset is The Broadview Savings and Loan Company, of which it owns 99.8%. 1/ William R. Heideloff is Broadview's president and chief operating officer ("Broadview's President"). Broadview's President played an integral role in the events discussed below.

Broadview was 58th in size among United States savings and loan associations, as measured by deposits, and 47th in size as measured by assets, as of December 31, 1983. Broadview files periodic and current reports with the Commission pursuant to Section 12(g) of the Exchange Act. Broadview had 2,973,400 shares of common stock outstanding held by 1,973 shareholders as of December 16, 1983. Broadview's stock is traded over-the-counter and quoted on the National Association of Securities Dealers Automated Quotation System.

C. Background

Broadview has suffered from recent trends in the savings and loan industry, particularly by its cost of deposits exceeding the return on its loans. It experienced losses of $2.2 million, $19.1 million, and $25.4 million in 1980, 1981, and 1982, respectively. Its shareholders' equity was halved in 1982 from $49.5 million to $24 million. Broadview reported in its 1982 annual report to shareholders that its net worth was more than $10 million below the minimum required by the Federal Savings and Loan Insurance Corporation. Broadview's response to the industry trends, beginning several years prior to 1982, was to increase its involvement in real estate acquisition and development loans, particularly in Florida.

Broadview's losses continued to mount in 1982, and its auditors considered giving the company a qualified "going concern" opinion on its 1981 financial statements. In response, Broadview attempted to improve its financial statements by a series of transactions, including the Sea Level Ranch transaction. 2/

1/ Both the parent and the subsidiary will be referred to as "Broadview" without distinction herein.

2/ Broadview's auditors in fact did not give a "going concern" opinion on Broadview's 1981 financials but rather inserted a milder "emphasis paragraph" in its opinion.

D. The Sale of the Sea Level Ranch

1. The Participants

The Sea Level Ranch transaction in the second quarter of 1982 involved four principal parties and a 3200 acre parcel in the Stuart, Florida area. In addition to Broadview, the transaction involved a limited partnership ("partnership"), which owned the land in question prior to the transaction. The partnership never made any principal payments after its initial investment of $2 million, and it stopped making interest payments in 1979 to the lender ("lienholder") which had financed the Sea Level Ranch. The partnership was informed by the lienholder in 1981 that it had to sell the Sea Level Ranch property. The partnership owed about $13 million to the lienholder as of the time of the Sea Level Ranch transaction in May 1982.

The lienholder, the third party to the transaction, is a publicly owned real estate investment trust which files periodic reports with the Commission pursuant to Section 12(g) of the Exchange Act. The lienholder's mortgage on the Sea Level Ranch was the largest in its portfolio at the time. The lienholder had been accruing interest income on the Sea Level Ranch since the payments by the partnership ceased. The lienholder's forebearance on the Sea Level Ranch ended, however, when its auditors told it that 1981 was the last year for which the auditors would allow the lienholder to accrue the interest on this loan. They refused to allow further accrual of interest because of its concerns that the indebtedness on the property was approaching its fair market value and that there was no development or activity on the property. The loss of this interest income would have been material to the lienholder because the Sea Level Ranch represented 20% of its investment portfolio. But for the sale of the Sea Level Ranch in May 1982, the lienholder would not have been allowed to accrue approximately $2 million in interest income from the Sea Level Ranch loan; failure to accrue such interest would have resulted in a doubling of the lienholder's losses in fiscal 1982.

The fourth party was a local real estate developer, ("local developer"), who ultimately purchased the Sea Level Ranch. The local developer had a history of acquiring property with minimal down payments financed by other investors and then attempting to increase the value by convincing state and local authorities to construct roads and otherwise upgrade the land uses. The local developer's policy was one of not investing any of his own money in real estate development transactions; he adhered to that policy with regard to the Sea Level Ranch.

The general partner of the partnership ("general partner"), the managing trustee of the lienholder ("trustee") and Broadview's President had been acquainted with each other for a number of years prior to the Sea Level Ranch transaction. Broadview and the lienholder jointly financed several real estate transactions. The local developer and the general partner had also been acquainted for some years as a result of their real estate activities in the Stuart, Florida area.

2. The Transaction

The local developer began a new round of negotiations with the partnership in late fall of 1981 or early 1982. 3/ The local developer's offer was not satisfactory to either the partnership or the lienholder because he was offering to put down only $1 million on the purchase of the Sea Level Ranch. While the local developer, the partnership and the lienholder were continuing to negotiate among themselves, the trustee introduced the local developer to Broadview's representatives around March 1982. Broadview and the local developer became acquainted and began to discuss, among other things, possible acquisition of the Sea Level Ranch.

Around late April or early May 1982, Broadview's President indicated Broadview's willingness to participate in acquisition of the land from the partnership on the following terms: Broadview would contract to purchase the land for $19.2 million from the partnership and would then assign the contract for a $4 million cash payment from the local developer. Broadview would also finance the local developer's purchase and development of the land with a $20 million loan, which included a $12 million payment to the partnership (about $10.5 million of which was to go to the lienholder) as well as funding in the loan for all of the local developer's interest payments on the loan for three years. In return, Broadview would receive from the local developer a 50% participation in the profits in the Sea Level Ranch development together with straight interest at the market rate for the loan and a mortgage on the property.

The local developer was unsuccessful in his efforts to obtain financing for the $4 million cash payment to Broadview. The local developer advised the trustee and Broadview's President

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3/ Prior to this time, the local developer had intermittently negotiated with the partnership to acquire the 3200 acre Sea Level Ranch parcel as well as with owners of an adjacent 4500 acre parcel ("the Hobe Sound tract").

of his inability to obtain private funding. It was at this point that Broadview's President showed the local developer how the lienholder could lend the local developer the $4 million, to be secured by a second mortgage on the land known as Hobe Sound tract, which was adjacent to the Sea Level Ranch and which the local developer was also in the process of acquiring. The lienholder agreed to lend the local developer the $4 million and the entire transaction closed on May 26, 1982 as previously outlined above. 4/ The lienholder's $4 million loan to the local developer came indirectly from the funds which Broadview disbursed to the local developer.

E. The Sale of the Hobe Sound Tract

The local developer had been negotiating for years to acquire the Hobe Sound property. On April 16, 1982, he acquired an option to purchase it for a purchase price of $29.9 million. Under the terms of the contract, $865,000 would be due on closing; a total of $9.5 million would be due over the next three years; and the balance would be due at the end of the fourth year. Although the local developer had arranged for a private investor, if necessary, to advance the $865,000 downpayment, he instead obtained the money out of the proceeds of the $20 million loan he received from Broadview in the Sea Level Ranch transaction. Broadview had designated about $1.5 million of the $20 million loan for "soft costs" and roadway acquisitions on adjoining properties. It was from these funds that the local developer obtained the down payment for the Hobe Sound tract.

Not only did Broadview advance the $865,000 down payment for the Hobe Sound property, but Broadview also advanced the other money the local developer needed to make the lienholder's

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4/ The structure of the transaction and the flow of funds are diagrammed in Exhibit A. Exhibit A shows the following chain of events which occurred on May 26, 1982: Broadview's assignment of the contract for the Sea Level Ranch to the local developer, Broadview's disbursement of $12 million of the $20 million loan to the partnership, the partnership's payment of $10.5 million to the lienholder, the lienholder's loan of $4 million to the local developer, the local developer's $4 million payment to Broadview and the local developer's down payment of $865,000 to purchase the Hobe Sound tract.

security meaningful. 5/ Thus, Broadview was at risk on both the Sea Level Ranch and Hobe Sound properties.

F. The Effect of the Transaction

All four parties involved in the transaction derived benefits from the Sea Level Ranch and Hobe Sound transaction.

Broadview structured the transaction in a way that it hoped would enable it to recognize $4 million as revenue immediately. This recognition allowed Broadview to show an apparent financial inprovement by reducing losses in the second quarter of 1982. In addition, Broadview acquired a 50% participation in the profits in the Sea Level Ranch, the recovery of which was at a substantial risk. 6/

The lienholder was initially paid $10.5 million of the $13 million it was owed in principal and interest on the Sea Level Ranch. Although the lienholder loaned the local developer $4 million of the $10.5 million it received from the partnership, it reduced its exposure on its loan to the partnership by $6.5 million. In addition, $4 million was now loaned to a different party, on different terms and on land which was being developed. As a result, the lienholder was able to persuade its auditors to allow it to accrue $2.4 million in interest on the Sea Level Ranch for the past fiscal year, 1982, which the auditors would have otherwise disallowed.

The partnership, which sold the Sea Level Ranch, recovered $1 million of its $2 million initial investment, and gained some hope of recovering its remaining investment and perhaps profiting if the local developer were successful. 7/

5/ The local developer used this money to improve the lienholder's position as a lienholder vis-a-vis the purchase money mortgagors of the Hobe Sound tract.

6/ The Sea Level Ranch loan was not only a large amount for Broadview, but it also involved raw land on which no development at all had occurred, unlike many of Broadview's other development loans.

7/ In addition to his $12 million cash payment to the partnership, the local developer gave the partnership a $7.2 million note secured by the Sea Level Ranch. The partnership then assigned this note to the lienholder. The partnership was thus effectively subordinated to both Broadview and the lienholder with regard to any future payments by the local developer.

The local developer had acquired the Sea Level Ranch and Hobe Sound properties without putting up any of his own money or assuming any risk.

G. Effect of Broadview's Improper Recognition of $4 million

On its Form 10-Q for the second quarter ended June 30, 1982, Broadview recognized revenue of $4 million from the Sea Level Ranch transaction. This recognition was material to Broadview's financial results for that quarter, in which it reported a net loss of approximately $2.5 million. This same $4 million profit was included in Broadview's cumulative results in its Form 10-Q for the quarter ended September 30, 1982 and was similarly material to Broadview's financial results for the nine months ended September 30, 1982 in which it reported a net loss of approximately $11.1 million. Broadview noted in both its second and third quarter 1982 Forms 10-Q that its improved earnings were attributable to gains from the sales of interest in real estate investments. Broadview intended to report the $4 million as income in its Form 10-K for 1982 but adopted the position on the Sea Level Ranch of the auditors who had been dismissed in November 1982, after the staff of the Commission questioned the appropriateness of such recognition.

H. Broadview's Communications in 1982 with Its Auditors

In soliciting its auditors' views on the Sea Level Ranch transaction, Broadview's President dealt with its auditors' engagement partner for the Broadview account. According to its auditors, Broadview's President and the engagement partner discussed the source of the local developer's $4 million down payment on at least two occasions: the first on or near May 26, 1982, the closing date; the second on October 4, 1982. On the first occasion, the engagement partner met with Broadview's President and other Broadview personnel at Broadview's offices. The participants had a copy of the AICPA industry accounting guide, Accounting for Profit Recognition on Sales of Real Estate (also known as the "Black Book"), physically present at the meeting. Referring to the Black Book, the participants reviewed several accounting questions presented by the transaction, including whether Broadview was "directly or indirectly providing" the local developer's $4 million payment to Broadview. According to the auditors, the engagement partner asked whether any of Broadview's loan disbursements were finding their way to the local developer. Broadview's President responded in the negative. The engagement partner further inquired whether the $4 million was "fresh capital", to which Broadview's President responded affirmatively. At no time did Broadview's President advise the engagement partner of the source of the $4 million or any of the circumstances surrounding it.

A second conversation on the same matter occurred on October 4, 1982. A number of partners of the then existing auditors were scheduled to meet on October 5, 1982 to discuss, among other things, the Sea Level Ranch transaction, which the auditors were re-examining. In preparation for the October 5, 1982 meeting, the engagement partner and the tax partner on the Broadview account met with Broadview's President the day before to review both transactions.

According to its auditors, at the October 4, 1982 meeting, Broadview's President again assured the engagement partner that none of the $12 million Broadview disbursed was finding its way to the local developer and that Broadview was not indirectly financing the local developer's $4 million down payment. In response to the engagement partner's question about whether the $4 million represented fresh monies, Broadview's President suggested that the local developer was a person of considerable financial resources and had many wealthy friends.

At the October 5, 1982 meeting, the then existing auditors were sufficiently disturbed by the partial information they knew about the Sea Level Ranch transaction that they tentatively decided to ask Broadview to reverse its recognition of the $4 million. Later that day, the engagement partner discovered information in documents concerning another transaction which recently had been provided to him by Broadview. These documents suggested that the lienholder had loaned money to the local developer in connection with the Sea Level Ranch acquisition. After confirming this fact with the lienholder and conferring with his partners, the engagement partner advised Broadview's President in a very heated meeting on October 6, 1982, that Broadview must reverse its recognition of $4 million in revenue.

I. Communications with Other Auditors

On or about October 6, 1982, shortly after Broadview was informed by its auditors that it must reverse its recognition of the $4 million profit from the Sea Level Ranch transaction, Broadview's management began looking for new auditors. Broadview determined to replace its auditors and set about interviewing other firms. Broadview contacted at least four of the "Big Eight" accounting firms about their views on whether revenue could be recognized immediately in the Sea Level Ranch and other transactions. Three of the firms would not allow Broadview to recognize the $4 million immediately. The first stated that before recognizing the $4 million, Broadview must prove that the Sea Level Ranch transaction was "real" by selling to another lender at least half of the $20 million loan to the local developer. The second firm would have required Broadview to sell the entire loan before it would allow it to recognize any income. The third firm, the lienholder's auditors, which knew more about the transaction than any of the accounting firms interviewed because of its audit of the same transaction for the lienholder, informed Broadview that it could not recognize revenue from the transaction because of the "circular" flow of the funds involved. Only the fourth firm agreed that Broadview could immediately recognize as income the $4 million from the Sea Level Ranch transaction, if minor changes were made. Broadview's management, which was dissatisfied with its auditors, then recommended to its board of directors that it dismiss its auditors and engage the fourth accounting firm. 8/ Broadview's board of directors acted upon this recommendation on November 1, 1982, and it was implemented on November 15, 1982.

II.

CONCLUSION

The reporting requirements of Section 13(a) of the Exchange Act necessarily include the requirement of supplying true and correct information. SEC v. Savoy Industries, Inc., 587 F.2d 1149 (D.C. Cir. 1978) cert. denied sub nom. Zimmerman v. SEC, 440 U.S. 913 (1979). A violation of the Section is established if annual or quarterly reports contain materially false and misleading statements regarding such items as the levels of a company's income. S.E.C. v. Kalvex Inc., 425 F. Supp. 310 (S.D.N.Y. 1975). Rule 4-01(a)(1) of Regulation S-X provides that financial statements not prepared in accordance with GAAP are presumed to be misleading. 17 C.F.R. 210.4-01(a)(1). No showing of scienter is required for a direct violation of Section 13(a) of the Exchange Act. S.E.C. v. Savoy Industries, Inc., 587 F.2d at 1167.

A. Broadview's Failure to Adhere to Pertinent Accounting Principles

Broadview's accounting for the Sea Level Ranch transaction as a sale of real estate and its recognition of the local developer's $4 million payment in the second quarter of 1982 as revenue was inappropriate under the applicable accounting

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8/ At the time Broadview changed auditors, certain of its Board members understood that only its then existing auditors disagreed with the accounting treatment sought by Broadview for the Sea Level Ranch transaction. The audit committee, which was also dissatisfied with its auditors, concurred in management's recommendation to change auditors, based in part on the audit committee's contact with the other firms.

principles, particularly the concept of substance over form. In this regard, Accounting Principles Board ("APB") Opinion No. 4 states that "financial accounting emphasizes the economic substance of events even though the legal form may differ from the economic substance and suggest different treatment." The AICPA industry guide, Accounting for Profit Recognition on Sales of Real Estate, (the "Black Book"), which governed the sale of the Sea Level Ranch, is also in accord that substance controls form. 9/

Broadview was not purchasing and selling real estate in this transaction 10/ but instead was financing the purchase by the local developer of the Sea Level Ranch. Broadview

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9/ The Black Book states in § 11:

> Economic substance should determine the timing of recognition, amount, and designation of revenue if the economic substance of a transaction differs from its legal form. Economic substance of a transaction may differ from its legal form in several ways. For example, a transaction that is in the legal form of a sale (that is, title to or possession of a product or other asset is transferred in exchange for cash or a promise to pay cash) may be in economic substance . . . (d) an agreement to loan or borrow funds . . . . Thus, instead of recognizing revenue and profit on the sale of the product or other asset, the appropriate accounting may be to recognize revenue and profit . . . as interest accrues . . . or by some other method that reflects the essence of the transaction.

10/ Assuming *arguendo* that Broadview in substance purchased and sold the Sea Level Ranch (rather than merely financing the local developer's purchase), the requirements of the Black Book would still have prevented Broadview from immediately recognizing as revenue the $4 million it received from the local developer. The Black Book provides that one of the key prerequisites to recognizing profit from the sale of real estate is that the collectibility of the sales price must be reasonably assured. Assurance of collectibility requires, among other things, that the buyer make a significant initial investment in the property, such as a down payment. The Black Book also provides that the initial down payment cannot be directly or indirectly provided by the seller of the real estate. Thus, even if Broadview "sold" the Sea Level Ranch to the local developer, it could not have immediately recognized the $4 million because the collectibility of the sales price was not reasonably assured in that Broadview indirectly provided the buyer with the funds to make the initial down payment.

provided him with the vehicle to make the purchase. As far as the local developer was concerned, the $4 million which was added to the purchase price represented the cost necessary to complete the transaction at no risk to him. The $4 million Broadview received from the local developer at closing was, at most, consideration for the loan in addition to the stated interest rate applicable to the $20 million commitment and the 50% equity kicker on the property. The $4 million payment was simply another term of the deal negotiated concurrently with all the other terms. Accordingly, Broadview should not have immediately recognized as revenue the $4 million it received from the local developer. 11/

B. Broadview's Restatement

After dismissing its auditors, Broadview filed a current report on Form 8-K on November 24, 1982, announcing a change in auditors due to disagreement over "income recognition in connection with three transactions consummated by [Broadview] in the first, second, and third quarters" of 1982. The Form 8-K, however, was devoid of any information about the nature of the disagreements or the financial significance of the the transaction.

As a result, the staff contacted Broadview and during January and February of 1983, obtained certain information from Broadview concerning these transactions. On the basis of this information, and after meetings with Broadview in March 1983, the staff refused to acquiesce in Broadview's accounting

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11/ In its subsequent restatement of its quarterly financial statements, Broadview deferred recognition of the $4 million and accounted for it as an adjustment to the yield on its loan to the local developer over the life of the project.

The accounting profession has recently published its views on transactions similar to the Sea Level Ranch transaction. A task force of the American Institute of Certified Public Accountants accounting standards executive committee ("task force") investigated the accounting used by financial institutions for various real estate acquisition, development or construction loans, noting that lenders in many cases have the same risks and rewards as owners or joint venturers. In such cases, the task force indicated that such loans should be accounted for as real estate investments or joint ventures, depending upon the extent of the financial institution's participation in the expected residual profit from the project. Journal of Accountancy pp. 51-54 (November 1983); see also CPA Letter p. 3 (November 26, 1984). Under this approach, recognition of any profit on the loan would be deferred until repayment of the loan or until the property was sold to an independent third party.

treatment of the Sea Level Ranch transaction as previously stated in its quarterly reports. Shortly thereafter, Broadview reversed the recognition of income from the Sea Level Ranch transaction in its 1982 Form 10-K which it was preparing to file. In March 1983, Broadview filed a Form 8 restating its reported earnings for the first three quarters of 1982.

C. Violation of Section 13(a) of the Exchange Act

The accounting treatment which Broadview afforded the Sea Level Ranch transaction, immediate recognition of revenue, was inappropriate and resulted in a material overstatement of Broadview's earnings. Broadview inaccurately stated in its June 30, 1982 and September 30, 1982 Forms 10-Q that the financial statements contained therein fairly presented Broadview's financial position, results of operations and changes in financial position. The above actions did not comply in material respects with Section 13(a) of the Exchange Act and Rules 13a-13 and 12b-20 thereunder. The appropriate accounting treatment required Broadview to defer recognition of the $4 million.

The Commission previously has noted the importance of accurate quarterly reporting by public companies, See In the Matter of Ronson Corporation Exchange Act Release No. 19212 (November 4, 1982). In Ronson, the Commission stated that:

> Interim financial reporting is an important part of [the integrated disclosure program] that is meant to ensure the continuous flow of meaningful current information to shareholders and to the trading markets. Because interim financial statements are unaudited, the investment community places particular reliance on the issuer and its management to accurately report interim results and provide it with accurate and timely information. It is essential for the issuer to be meticulous in the preparation of such financial statements.

The Commission will not tolerate an issuer's efforts to avoid compliance with GAAP and with its financial reporting requirements through the elevation of the form of a transaction over the actual substance in an attempt to recognize revenue or to otherwise distort the financial results or condition of an issuer. Few types of violative conduct destroy investor confidence in the integrity of the securities markets more than the presentation of financial statements which contain an inaccurate and misleading view of a company's financial condition.

D. Dangers Inherent in Opinion Shopping

This matter also illustrates the apparent dangers inherent in "opinion shopping." The Commission has emphasized the importance of maintaining an auditor's objectivity and integrity, with its most recent pronouncement coming in a Rule 2(e) proceeding in June 1984 in the context of a discussion of an issuer's decision to change auditors. 12/ Certainly it is not per se illegal or improper for an issuer to change the independent accounting firm which conducts an audit of its financial statements. However, if the manner in which the issuer changes its auditors restricts the independence of the new auditors or calls into question their objectivity, such conduct erodes the public's belief in the integrity of both the financial markets and the independent audit function. 13/ The Supreme Court in the recent Arthur Young decision noted that:

> . . . [T]he independent auditor assumes a public responsibility which transcends any employment relationship with his client . . . [and] owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the auditor maintain total independence from his client at all times and requires complete fidelity to the public trust. 14/

In this case, prior to making a decision as to which accounting firm to retain, Broadview contacted at least four Big Eight accounting firms, each of which was asked its opinion of the accounting treatment which Broadview afforded certain transactions. Three of the firms informed Broadview that its accounting treatment for the Sea Level Ranch transaction was incorrect. The only firm that agreed with Broadview's accounting treatment was promptly engaged.

12/ In the Matter of Stephen O. Wade, Ralph H. Newton, Jr., and Clark C. Burrit, Jr., Securities Exchange Act Release No. 21095 (June 25, 1984) (noting that it is very important that an auditor maintain his integrity, objectivity and skepticism with respect not only to existing clients but also prospective clients in order to avoid the appearance of "opinion shopping").

13/ In this particular matter, it is significant to note that Broadview's firing of its existing auditors has been the focus of several articles in the media which raised questions about the objectivity and independence of Broadview's present auditors.

14/ U.S. v. Arthur Young, _____ U.S. _____, 104 S.Ct. 1495, 1503 (1984).

Auditors should act cautiously when approached by an issuer in search of an opinion which differs from that given by its existing auditors. A change in auditors resulting from disputes over the interpretation or application of GAAP should be a "red flag" to prospective auditors as it is for the Commission in its review of a change of auditors. The auditor should be especially concerned about the accounting for the transaction in question, but also must be concerned about the nature of the relationship that is established with any new client which develops from a "shopping" situation. In cases involving the changing of auditors under questionable circumstances, the scope of the Commission's review will not be limited to the actions of the issuer but will also encompass the conduct of the auditors as well. 15/ Auditors who condone or assist in an issuer's efforts to circumvent GAAP may themselves violate the federal securities laws.

The independent auditor has the responsibility to maintain a standard of professionalism which assures the public that he will maintain his independence and objectively review the financial statements of his client. Acquiescence to "opinion shopping" taints the professionalism of the auditor and more importantly, erodes the public confidence in the audit function itself.

III.

FINDINGS

Based on the foregoing, the Commission finds:

(a) Broadview's recognition in the second and third quarter of 1982 of $4 million as revenue from the Sea Level Ranch transaction was inappropriate because it was in contravention of GAAP as stated in APB Opinion No. 4;

(b) Broadview's inappropriate recognition of revenue resulted in a material overstatement of income in its financial statements in its June 30, 1982 and September 30, 1982 quarterly reports on Form 10-Q filed with the Commission; and

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15/ In this regard, the Commission will, among other things, review the public filings required when an issuer changes auditors, such as reports on Forms 8-K and 10-Q, to determine whether the change of auditors raises questions as to the appropriateness of the accounting and independence of the accountants involved. Issuers should be careful to describe adequately the circumstances surrounding any reported dispute or change of auditors.

(c) Broadview violated Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-13 thereunder, in that it filed with the Commission quarterly reports on Form 10-Q pursuant to Section 13(a) of the Exchange Act which contained the financial statements referred to in (b) above.

IV.

BROADVIEW'S OFFER OF SETTLEMENT

Broadview has submitted an Offer of Settlement in which, solely for the purpose of this proceeding or any other proceeding brought by or on behalf of the Commission or in which the Commission is a party and without admitting or denying the findings herein, it consents to the issuance of this Order.

A. In the Offer of Settlement, Broadview undertakes to perform the following for a period of three years from the date of the ORDER:

(1) Broadview will have its independent auditors conduct an interim review, in accordance with Statement on Auditing Standards No. 36, of its quarterly financial statements prior to Broadview's filing of such statements with the Commission;

(2) Broadview will have its Audit Committee review, on a quarterly basis, the accounting for all real estate transactions involving acquisition, development or construction loans in excess of $5 million. Broadview shall make available to the Audit Committee any assistance which the Audit Committee requires, in its judgment, to perform its review. The Audit Committee shall make a determination whether the accounting for such real estate transactions is in accordance with GAAP.

B. Broadview also undertakes to the following:

(1) Broadview will, within ten (10) days of the end of the month during which the Commission initiates these proceedings and issues the ORDER in this matter, attach a copy of the ORDER herein as an exhibit to a current report on Form 8-K to be filed with the Commission; and

(2) Broadview will require that its management adhere to GAAP in recognizing revenue from real estate transactions.

V.

ORDER

In view of the foregoing, the Commission deems it appropriate and in the public interest to accept the Offer of Settlement of Broadview and, accordingly,

IT IS HEREBY ORDERED that Broadview:

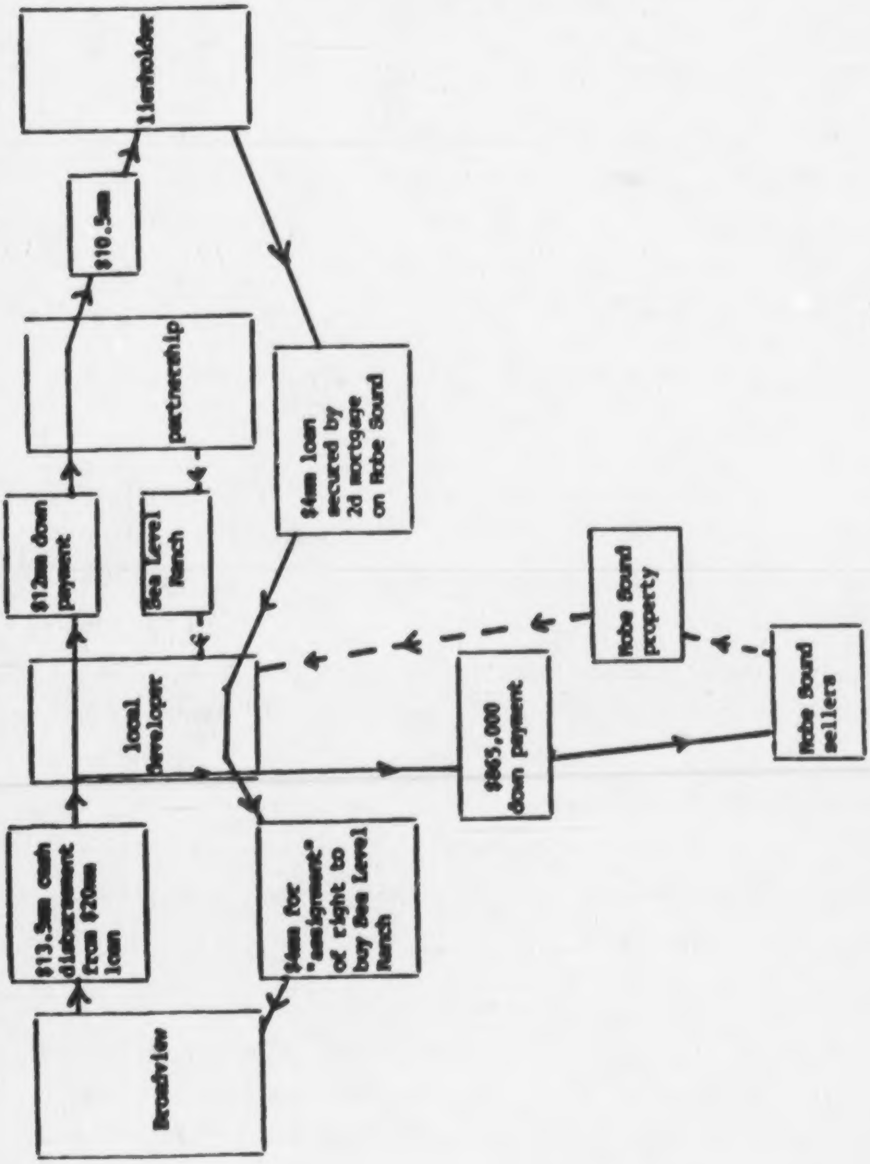
(1) Comply with Section 13(a) of the Exchange Act and Rules 13a-13 and 12b-20 promulgated thereunder; and

(2) Comply with the undertakings set forth in its Offer of Settlement.

By the Commission.

John Wheeler
Secretary

Exhibit A


Broadview
$13.5mm cash disbursement from $20mm loan
local Developer
$12mm down payment
partnership
$10.5mm
lienholder
Sea Level Ranch
$4mm loan secured by 2d mortgage on Hobe Sound
$4mm for "assignment" of right to buy Sea Level Ranch
$865,000 down payment
Hobe Sound property
Hobe Sound sellers

RESPONSE TO QUESTION OF SENATOR PROXMIRE,

Hearing of April 17, 1985

Question 3. Market Regulation/Executive Staff.

I see that this year 1985 estimates for staff positions in the Regulation of Securities Markets will decrease by 15 staff positions from 268 in 1984 to 253 in 1985 while the Executive Staff will increase from 38 to 42 and the Executive Director's staff will increase from 16 to 19.

Why the cut in Market Regulation and the increase in the Executive Staff?

Answer. The Market Regulation staff was reduced by fifteen positions in order to provide the additional positions required by the Division of Corporation Finance to increase the level of review of annual reports (Forms 10-K) filed with the Commission. This reprogramming reflected clear Commission priorities and received the support of all Commissioners. As indicated in their individual testimony before the Subcommittee on Telecommunications, Consumer Protection, and Finance of the House Committee on Energy and Commerce, the Commissioners believe that the reprogramming left the market regulation program sufficiently staffed.

The Executive Staff was increased by four positions, from 38 in 1984 to 42 in 1985, in order to create an Office of Internal Audit. The creation of this office within the Executive Staff was specifically mandated by the Congress in its 1985 appropriation for the Commission.

The Executive Director's staff has increased from 16 positions in 1984 to 19 positions in 1985. The increment reflects the transfer of the Equal Employment Opportunity Office to the staff of the Executive Director.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

HEARING OF APRIL 17, 1985

Question 4. Corporate Finance.

Part a. I have been told that 60 percent of the Division of Corporation Finance has been with the Commission less than one year and that there is no formal or informal training program for new staff.

* How do you account for the high turnover in corporation finance and how do you respond to criticism that new entrants are inadequately trained for their responsibilities?

Answer. While the Division does have a number of employees that have less than one year, the reference to 60 percent is too high. As of June 30, 1985 the figure is 30.5%. The Division's turnover rate, has declined over the past four years from over 46% in FY 1981 to its present rate of 17.9% for the first nine months of fiscal year 1985. We believe the turnover is due primarily to high salary incentives in the private sector. In seeking candidates to fill vacancies the Division applies criteria that emphasizes background skills and knowledge necessary for its work. While some attorneys are hired directly out of school many are not. In addition, we continually seek experienced accountants and financial analysts.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

HEARING OF APRIL 17, 1985

Part b.

* Wouldn't the Commission be well advised to establish some kind of minimal training program for new entrants in this division?

Answer. The Division has procedures for training new as well as its senior staff. We are presently devoting increased staff years to training in fiscal 1985 as compared to the 2.8 staff years spent during fiscal year 1984. An in-depth training program was conducted for new employees in August 1984.
On-going training is conducted for the staff as the result of topical matters, such as changes in disclosure requirements, Rule or Form changes, accounting developments and emerging issues. In addition, the Division has developed various manuals to facilitate staff knowledge and consistency of procedures in dealing with filings.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

HEARING OF APRIL 17, 1985

Part c. In the early 1970's when the Commission created the integrated disclosure system the Form 10-K annual report became the cornerstone disclosure document. The theory was that since seasoned companies file periodic reports, including the 10-K, why not just incorporate such documents (without delivering them) into the prospectus used to sell securities so that the costs and time spent could be reduced. The SEC claimed that its objective would be to concentrate more of its efforts on reviewing periodic reports, especially 10-K's.

* How many 10-K's are reviewed by the staff?

Answer. During FY 1980, the first stage of the integrated disclosure system was adopted. This action included revision of the annual report (Form 10-K) to facilitate incorporation by reference of that report in Securities Act filings. During FY 1980, of the 8,344 10-K's filed, 417 were fully reviewed. During fiscal year 1984, 9,374 10-K's were received. Of those, 1,283 or 13.7% were fully reviewed. It is currently projected that of the 10,550 10-K's expected to be filed during fiscal year 1985 1,951 (18.5%) will be fully reviewed.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

HEARING OF APRIL 17, 1985

Part d.

* How many comment letters have been issued on 10-K's?

Answer. During the fiscal year ended September 30, 1984 930 comment letters were issued on Form 10-K filings.

Part e.

* Does the Division of Corporation Finance need more staff to review periodic reports on a regular basis?

Answer. During 1984, the Division of Corporation Finance reorganized to, among other things, improve support to the integrated disclosure system primarily through increased reviews of Form 10-K's. Additional resources were allocated to the review function of the Full Disclosure Program. The number of review Branches was increased from ten to twelve.

Based upon currently projected workload for fiscal year 1986, it is felt that present staffing together with anticipated benefits stemming from our efforts toward automation, continued regulatory simplification and procedural efficiencies will be sufficient to discharge the Division's statutory mandate.

RESPONSE TO QUESTION OF SENATOR PROXMIRE,
Hearing of April 17, 1985

Question 5. Staff Turnover.

Part a. What was the staff turnover rate at the Commission in 1984?

Answer. The overall turnover rate at the Commission in 1984 was 16.9%. The turnover rate by occupation at the Commission in 1984 was as follows:

Attorneys	20.6%
Financial Analysts	9.3%
Accountants	9.3%
Clerical/Support	27.3%
Securities Compliance Examiners	15.1%
Investigators	6.7%

Part b. What are you doing to encourage career advancement at the Commission and to retain a professional staff at mid-levels?

Answer. The Commission has taken several steps to recognize and retain its mid-level professional employees. For example, the Commission:

(1) encourages new professional staff to make a three-year commitment to the Commission;

(2) promptly effects merited promotions, reassignments and other personnel actions for its mid-level staff;

(3) dedicates a significant amount of funds for incentive awards to mid-level staff based on their performance (in 1985, $162,000 has been earmarked for this group);

(4) makes a special effort to recognize its staff by giving them honorary awards in formal ceremonies and by nominating them for honorary awards that are sponsored by organizations external to the Commission;

(5) runs a very successful training program for new supervisors and managers to assure that they have the skills required to manage successfully; and

(6) conducts in-house courses for its mid-level staff on stress and "burn-out" avoidance.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearings of April 17, 1985

Question 6. Investment Management Regulation

Part a. In various public statements during the last several years, you have indicated the view that a legislative proposal should be prepared to amend the Investment Company Act of 1940.

Could you give us some idea of the types of changes to the Investment Company Act of 1940 you believe are necessary? More specifically, in what areas do you believe the Commission's efforts to regulate (or deregulate) the mutual fund industry under the Commission's existing administrative authority have been unsuccessful?

Answer. The staff is currently studying what changes, if any, need to be made in the Investment Company Act of 1940. As you know, that Act was designed to regulate a vastly different industry from the one which exists today. While some amendments have been made to the Act, and the Commission has adapted the Act to situations unforeseen in 1940 by rule and exemptive order to the extent of its authority, to date no comprehensive review has been undertaken on this 45 year old regulatory structure. A necessary part of the staff inquiry will be to determine where problems exist that the Commission does not have the power to correct by administrative action. It is premature now to list the types of changes the Commission may decide are necessary at the conclusion of the staff inquiry.

Part b. Has the Commission given any thought to creating a self-regulatory organization similar to the NASD for the investment adviser industry which would set qualifications standards and establish rules of fair practice under which violators could be disciplined by the organization?

Answer. The Commission has not considered such a self-regulatory organization.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Investment Management Regulation

Part c. Rule 12(b)1 under the Investment Company Act allows a fund to pay for distribution of its shares if the disinterested directors find that it is advantageous for the fund to do so. In recent months there has been a proliferation of 12(b)1 plans in which the cost to funds for distribution have increased to the point where such costs could approach or even exceed the investment management fees.

Is the Commission concerned about this?

If so, what measures are being taken to alleviate this possible abuse?

Answer. The Commission adopted Rule 12b-1 in 1980 following a lengthy public rulemaking proceeding. The rule permits mutual funds to spend fund assets to finance activities that promote the sale of fund shares, provided that extensive procedural steps are followed. All distribution payments must be made pursuant to a plan which, among other things, must be approved by shareholders and by the fund's board of directors and by its independent directors. The number of funds that have adopted Rule 12b-1 plans has steadily increased since 1980. As of the end of 1982, approximately 100 funds had adopted 12b-1 plans; as of the end of 1983, the number had increased to 250 and at the end of 1984, the number was about 375. There are approximately 1600 registered mutual funds.

Expenditures under Rule 12b-1 plans vary depending upon the nature of the fund and the distribution activities to be financed. For example, the average plan expenditures by money market funds approximate .25% of average net assets. Equity funds generally provide for larger expenditures but average about .50%.

The Commission's staff has been following developments under Rule 12b-1. Staff concerns to date have focused primarily on making sure that mutual fund prospectuses adequately disclose the existence of 12b-1 plans and the amount of fund assets that the fund contemplates spending. In November 1984, the Commission proposed for comment several changes to registration form for mutual funds to improve the quality of prospectus disclosure in this area. The Commission will consider staff recommendations this fall on whether to adopt the proposed changes.

Although a few 12b-1 plans permit expenditures in excess of advisory fees, the staff is not inclined to recommend that the Commission regulate the amount that can be spent on distribution activities. For the present, the staff believes the Commission should avoid rate making in this area because the marketplace should exercise a reasonable measure of discipline. Fund distribution expenditures can, of course, adversely affect performance if expense ratios do not improve as the fund increases in size. The fund may then lose existing and prospective shareholders. It may, however, ultimately be necessary to consider limiting the kinds of distribution activities that can be paid for with fund assets.

Part d. In view of the Commission's heavy burden of enforcement, will the Commission recommend legislation to give individuals a private right of action under the Investment Advisers Act?

Answer. While a limited private right of action exists under the Investment Advisers Act, the Commission has not considered whether to make a legislative recommendation on private rights of action.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing on April 17, 1985

Investment Management Regulation

Part e. Rule 12d3-1 under the Investment Company Act was amended last summer to increase greatly the circumstances under which mutual funds can invest in broker-dealers. In approving this amendment did the Commission consider whether there might be any conflict between a mutual fund adviser's duty to select the best available investments for the fund on the one hand, and the adviser's desire to stay on the good side of dealers in fund shares on the other hand?

Answer. Yes.

In proposing and adopting Rule 12d3-1 and related disclosure requirements, the Commission did consider the potential conflicts of interest that may arise if an investment company is able to acquire securities issued by its regular brokers or dealers. */ We believe that these potential conflicts are addressed by the qualitative and quantitative

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*/ The Commission recently adopted Rule 10b-1 to define the term "regular broker or dealer." See Investment Company Act Release No. 14193, dated October 12, 1984. That rule states that an investment company's regular brokers or dealers include: the ten brokers or dealers that received the greatest dollar amount of brokerage commissions by virtue of direct or indirect participation in the company's portfolio transactions during the company's most recent fiscal year; the ten brokers or dealers that engaged as principals in the largest amount of portfolio transactions of the investment company during the company's most recent fiscal year; and the ten brokers or dealers that sold the largest dollar amount of securities of the investment company during the company's most recent fiscal year.

conditions of the revised rule and by new registration statement and periodic reporting requirements. */

Under the revised rule, an investment company may acquire securities issued by a person that has derived more than 15% of its gross revenues from securities related activities. The issuer of the acquired securities could be a regular broker or dealer for the investment company or the parent of a regular broker or dealer that derives more than 15% of its gross revenues from its subsidiary's securities related activities. However, under the rule as revised, an investment company may only acquire equity securities that meet the Federal Reserve's margin requirements or debt securities that are determined to be investment grade by the investment company's board of directors. This condition minimizes the company's ability to make a bad investment just to stay on the good side of its regular brokers or dealers.

The revised rule also limits the amount of securities of any one issuer that an investment company may acquire where the issuer derives more than 15% of its gross revenues from securities related activities. Under the rule, an investment company may invest no more than 5% of the value of its total assets in the securities of such an issuer. Further, the company's investment in the equity securities of that issuer cannot exceed more than 5% of the outstanding securities of that class and

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*/ See Investment Company Act Release Nos. 13725, dated January 17, 1984, proposing revised Rule 12d3-1 and 14036, dated July 13, 1984, adopting the revised rule.

Where the regular broker or dealer is an affiliate of the company's investment adviser principal underwriter or promoter, there could be no potential conflict of interest because paragraph (c) of the rule makes exemptive relief unavailable for investment company acquisitions of the securities issued by those entities or their affiliates.

the company's investment in the debt securities of that issuer cannot exceed more than 10% of the principal amount of debt outstanding. This condition prevents the company from loading its portfolio with securities issued by its regular brokers or dealers or parents just to stay on the good side of the issuer.

At the time that revised Rule 12d3-1 was adopted, the Commission also amended investment company registration statement forms to require the registrant to identify any regular broker or dealer (or its parent) whose securities the registrant acquired during the most recent fiscal year if more than 15% of the issuer's gross revenues were derived from securities related activities. The new registration statement items also require the registrant to disclose the value of the registrant's aggregate holdings of that issuer's securities as of the close of the registrant's most recent fiscal year. The Commission incorporated complementary disclosure requirements in a new semi-annual reporting form for investment companies, */ requiring the company to disclose its aggregate securities holdings at the end of the reporting period.

These disclosure requirements were designed to give shareholders and the Commission a complete picture of the extent to which investment companies are relying on the revised rule to acquire securities issued by their regular brokers or dealers. Disclosures to date indicate that only a handful of registrants have made such acquisitions. We intend to monitor the situation closely, however, and will re-examine the rule's conditions if it appears warranted.

Wholly apart from these regulatory controls, it should be remembered that the mutual fund industry is highly competitive, and a fund's portfolio manager has a strong incentive to resist making unwise investments in securities issued by any broker-dealer, because of the potential adverse impact this may have on the fund's performance and attractiveness to investors.

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*/ See Investment Company Act Release No. 14299, dated January 4, 1985, adopting Form N-SAR.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Question 7. Options Trading.

The SEC has long-forbidden side-by-side trading of stocks and options for fear of stock manipulation and other market abuses but recently you authorized six exchanges to trade options on over-the-counter stocks and conditionally allowed the National Association of Securities Dealers to conduct a pilot project in over-the-counter options trading.

Why the change in the Commission's position? What makes today's climate any different from in the past?

Answer. The Commission has not yet authorized any exchange or the National Association of Securities Dealers ("NASD") to trade options on over-the-counter ("OTC") stocks side-by-side with the stocks underlying such options (so-called "integrated market making"). As is more fully described in the Commission's release approving the trading of OTC options products by the exchanges and the NASD ("OTC Options Release"), the Commission only approved, in concept, a one-year pilot program in integrated market making for OTC market makers in the six most active OTC stocks if (1) the Commission determines in a separate proceeding both to grant exchanges unlisted trading privileges in these stocks and to approve integrated market making on exchanges in these six stocks; and (2) equity and options audit trails are in place prior to the commencement of this pilot.

The Commission determined that a number of benefits might be obtained through a pilot program in integrated market making. In particular, the Commission believes permitting integrated market making may improve the quality of the markets for stocks and its related option. In addition, the Commission was cognizant of the fact that the prohibition on integrated market making might substantially affect the NASD's ability to compete for market share with the exchanges in these options.

In making this decision, the Commission also was cognizant of changes in the OTC market since the Commission's Option Study. First, there is last sale reporting on all OTC stocks eligible for options trading, permitting much more effective monitoring by investors of trading activity in both the option and underlying stock. Second, the NASD's developing audit trails for both OTC options and the stocks underlying them, permitting far more efficient surveillance of manipulative or abusive activity involving the option of underlying stock.

Notwithstanding these major advances in the OTC market, the Commission chose to limit its pilot in integrated market making to the six most actively traded OTC stocks. In light of the intensive competition and dispersion of market share in these six stocks, the Commission believed that there were not significant risks that integrated trading would result in manipulative or abusive trading activity.

RESPONSE TO QUESTION OF SENATOR PROXMIRE,

Hearing of April 17, 1985

Question 8. New products.

Part a. With the proliferation of new and complex products and the opportunity for more ingenious fraudulent activities, do the SEC regional offices have enough resources.

Answer. Yes. The proliferation of new and complex products in the securities context is a development which the Commission's regional offices are addressing in their inspection and enforcement programs. The staff has embarked on a concerted effort to maximize its productivity through, among other things, greater utilization of computers, streamlined examination procedures, improved case selection techniques, enhanced targeting of inspections and expanded access to data relating to the entities registered with the Commission. Continuing efforts are also underway to familiarize both our home office and field office staff with the new investment vehicles coming on-line with which they must deal. The positive results of this push for greater efficiency in our operations have been evidenced by higher numbers of enforcement actions filed, filings examined and examinations conducted.

Part b. Also, are the regional offices able to employ the sophisticated and experienced staff necessary to protect the public with respect to these new products?

Answer. Yes. The SEC, including its regional offices, has been fortunate in that it has been able to attract an extremely competent professional staff. The Commission's high reputation for quality, sustained over the years, has facilitated efforts to recruit top graduates from colleges and business and law schools. The Commission has experienced turnover among its professional staff, more so in certain parts of the country than others. As previously indicated, the widening gap between public sector and private sector salaries also has had an impact. Notwithstanding these factors, however, the SEC has maintained a core of sophisticated and experienced employees who, coupled with the fresh talent coming into the Commission each year, have given the agency an effective, motivated workforce capable of providing an appropriate level of public protection.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Question 9. Global Trading Systems

In your budget submission you state that, "with the emergence of global securities markets, the Commission will be confronted by a number of important policy issues." What are some of the important policy issues you are referring to and how do you plan to address them?

Answer. Important policy issues raised by the internationalization of the securities markets include (1) ways of ensuring adequate investor protection in the face of the emergence of global trading; (2) ways of facilitating multinational offerings in the U.S. and other countries; and (3) the development of efficient trading markets across national borders.

(1) The Commission is engaged in a number of ongoing efforts intended to ensure adequate investor protection in the face of the internationalization of the securities markets. Protecting investors is considerably more difficult in an international context. For one, the surveillance mechanisms in place in our domestic markets are more extensive than those abroad. The Commission's investigative subpoena authority is limited to persons within the United States. And it is often difficult to obtain information regarding transactions effected through banks and securities firms located in countries with secrecy or blocking laws. Commission programs and actions to deal with these problems of investor protection include the following.

First, the Commission has taken steps to ensure that foreign issuers seeking access to the U.S. capital markets provide adequate disclosure to U.S. investors. The Commission in 1979 adopted Form 20-F, a consolidated registration statement and annual report for foreign private issuers, and in 1982 adopted an integrated disclosure system for such issuers.

Second, the Commission and the self-regulatory organizations under its oversight provide electronic and other surveillance and a substantial enforcement presence in the United States securities markets designed to ensure that insider trading, manipulation and other securities misconduct is detected, whether by foreign or domestic entities.

Third, the Accord concluded with Switzerland in 1982 removes the haven of the Swiss secrecy laws from those who would trade on inside information. The Swiss Accord, while limited to insider trading in cases of tender offers, is an historic precedent for developing cooperative means for obtaining information from foreign jurisdictions.

Fourth, the Commission is pursuing cooperation with other foreign countries on enforcement issues, and is considering various alternative to ease enforcement difficulties in cases involving foreign nationals.

Fifth, the Commission is litigating enforcement actions against persons engaging in insider trading through foreign entities, including trading in the securities of Santa Fe International Corp. and St. Joe Minerals Corporation. In both cases, the Commission used U.S. Court process and mutual assistance agreements to obtain information regarding the identities of the persons involved who had traded through Swiss banks.

(2) In March 1985, the Commission issued a release (Release No. 33-6568) seeking public comment on issues involved in multinational securities offerings. The release sets forth two conceptual approaches to harmonizing disclosure and distribution practices for such offerings in the United States, the United Kingdom, and Canada. Under the first, the "reciprocal" approach, all three countries would agree that a prospectus accepted in an issuer's domicile that meets certain standards would be accepted for offerings in each of the other participating countries. Under the second, the "common prospectus" approach, the participating nations would attempt to develop a common prospectus to be simultaneously filed with each country's securities regulators. The United Kingdom and Canada were chosen for consideration because their issuers use the U.S. capital markets frequently, they share a common language with the United States, and their disclosure requirements most closely resemble those of the United States. Specific questions are posed for comment. Either approach will require close cooperation with government officials in Canada and the United Kingdom, as well as with the states. The concept release provides a framework for public comment and, hopefully, fruitful dialogue.

(3) In April 1985, the Commission issued a release soliciting public comment on a variety of issues relating to the operations of the international securities markets. Among the issues on which comment was requested were:

-- the need to facilitate international trading;

-- alternative market structures, such as simultaneous trading in different national markets, increased coordination between domestic and foreign markets, and "around-the-clock" in-house trading;

-- whether arbitrage activity will be sufficient to reduce pricing disparities in multiple market trading or whether intermarket linkages are preferable;

-- linkage of international securities clearance and processing facilities;

-- cooperation between national regulatory bodies in all of these areas.

This release is intended to provide a forum for consideration of the issues raised by the internationalization of trading markets and for a discussion of the manner in which global trading markets should develop.

RESPONSE TO QUESTION OF SENATOR WILLIAM PROXMIRE

Hearing of April 17, 1985

Question 10. International Accounting Standards

What concrete efforts have been made by the SEC to integrate international accounting standards and securities trading practices?

Answer. The International Accounting Standards Committee (IASC) is the only world-wide standard setting body. Professional accounting bodies in some fifty countries, including the American Institute of Certified Public Accountants, are now members of that body. IASC members agree to use their best endeavors to ensure that auditors satisfy themselves that international accounting standards are complied with in all material respects.*/ In light of the relatively advanced state of the financial accounting and reporting models in the United States, no material differences have occurred between the requirements of the United States and the IASC. Therefore, it has been unnecessary for the SEC to take any direct action to integrate international accounting standards in the United States. The SEC has, however, assumed an active role in efforts to the promote the international harmonization of financial accounting and reporting standards.

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*/ IASC standards attempt to narrow differences in the measurement of the elements of financial statements by narrowing available alternatives. Such narrowing process often results in the endorsement of one or more acceptable methodologies in an IASC standard.

The Office of the Chief Accountant maintains communications with various national and international standard-setting bodies and comments on the proposed standards of such bodies from time to time. A staff member from the Office serves as the United States' representative to regular meetings of working groups on international accounting and reporting standards established by the United Nations and the Organisation for Economic Cooperation and Development (OECD).

The OECD sponsored an international forum on the harmonization of accounting and reporting standards in April 1985. The U. S. delegation to the forum included, in addition to its regular members, the Chairman of the Financial Accounting Standards Board, a corporate executive, a partner of a major accounting firm and two staff members of the General Accounting Office. The delegations from other OECD-member countries also included representatives of standard setting bodies, as well as users and preparers of financial statements.

The harmonization of accounting standards is a long-term process; ongoing efforts are expected to continue and should favorably affect the efficiency of world capital markets.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Question 11. Settlement Period.
Is the SEC undertaking any sort of study about whether the traditional five-day settlement period for securities traders can be shortened or accomplished on a real-time basis?

Answer. No. This subject was discussed at the Division of Market Regulation's April 1984 Securities Processing Roundtable. Participants there concluded that efforts to shorten the traditional five-day settlement period likely would create more problems than benefits, at least near-term. Discussions, nevertheless, have continued in the industry, and SEC staff have sought to encourage those conversations. Indeed, clearing agencies have been studying ways to enhance securities processing that would enable the industry to evolve toward shortened "regular-way" trade settlement. These enhancements include earlier clearing corporation guarantees of settlement obligations (currently these arise on the fourth day after trade date) and earlier corresponding mark-to-the-market payments (currently these also are required on that day). Moreover, in cooperation with the clearing agencies, the national securities exchanges and the National Association of Securities Dealers, Inc. have established small order automated execution systems that effectively "lock-in" the terms of each trade. These systems thus eliminate the need for comparison processing and therefore the SEC is and will continue to coordinate securities industry efforts to improve efficiency and safety within the National Clearance and Settlement System. For example, rules of the Midwest Stock Exchange and the Pacific Stock Exchange, approved by the SEC, already allow next-day settling trades. Also, the New York Stock Exchange currently is operating, under SEC oversight, a program that allows next-day settling trades. Finally, the Commission has hosted industry meetings focused on advancing within the five-day cycle certain predicates to actual settlement. These include earlier clearing corporation guarantees of settlement obligations (currently these arise on the fourth day) and earlier mark-to-the-market payments (currently these are required also on the fourth day). Real-time processing already is possible for the comparison stage of some trades, especially trades executed on automated execution systems.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Question 12. Internationalization

How does the Commission use its membership in the International Association of Securities Commissions and Similar Organizations to enhance cooperation among countries in enforcing securities laws?

Answer. The Commission has found its membership and participation in the International Association of Securities Commissions and Similar Organizations very helpful in enhancing cooperation among participating countries and at mininal costs. The principal benefits are threefold: (1) it provides a forum for enhanced understanding of the securities regulations and markets of the participating countries; (2) it has proved helpful in cross-border investigations; and (3) it is a natural link to the world's securities markets.

The Association is the only international forum of its kind where high level delegations of securities market regulators can share views and experiences concerning the development, improvement, promotion, expansion, and regulation of their securities markets. By participating in the conferences, the Commission improves its relationships with other countries through a dialogue designed to aid in the exchange of information and experiences.

As an outgrowth of this exchange, the Commission has developed informal relationships with law enforcement agencies in a number of countries which facilitate mutual access to information. On various occasions, these relationships have resulted in the Commission obtaining access to information and assistance in cross-border investigations that would not otherwise have been available or available on a timely basis.

The resolutions approved at the annual conferences are considered important policy guidelines, even though they are not binding on members. The Commission's delegates to the annual conferences have been very influential in the formation of these resolutions. On request, the Commission's staff has studied and helped in the development of securities laws of several developing countries. We have also provided hands-on training for the professionals of various securities commissions. As a result of such activities other member countries variously have used the federal securities laws and regulations as a model for their own markets. Thus, the Organization has provided yet another facility for the development of an interface of various securities markets, a necessary element in the inevitable internationalization of the free world's capital markets.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Question 13. Soft dollars.

What abuses, if any, have taken place in the "soft dollar" sector and what regulatory action, if any, do you contemplate taking?

Answer. Under Section 28(e) of the Exchange Act, a money manager will not be deemed to have violated any fiduciary duty solely because he causes an account to pay more than the lowest available commission rate if he makes a good faith determination that the rate paid was reasonable in relation to the value of research and brokerage services provided by the broker executing the transaction. In 1976, the Commission issued an interpretive release on various issues under Section 28(e). Among other things, the Commission stated that goods and services that were "readily and customarily available and offered to the general public on a commercial basis" did not constitute research. Thus, a money manager that purchased such things as magazine and newspaper subscriptions, airline tickets and quotation equipment with commission dollars (i.e., so-called "soft dollars") could not claim the protection of Section 28(e).

Over the past eighteen months, the Commission and its staff have been advised that there are some abuses occurring in the area. For example, in purported reliance on Section 28(e), some money managers are paying for investment seminars in foreign countries, along with the cost of airfare, hotels and meals, in soft dollars. This practice is clearly inconsistent with Section 28(e) and may involve violations of the antifraud provisions of the federal securities laws. The Commission's staff has conducted several inspections of broker-dealers and money managers to detect abuses. Where appropriate, the Commission will take enforement action. The Commission's staff is also in the process of preparing an interpretive release to provide guidance in some of the "gray" areas under Section 28(e).

RESPONSE TO QUESTION OF SENATOR PROXMIRE,
Hearing of April 17, 1985

Question 14. Public Utility Holding Company Act.

Part a. What is the basis for your statement in the budget submission that "The Commission anticipates positive action on the repeal of the Public Utility Holding Company Act?"

Answer. Since the Commission first voted in favor of PUHCA repeal in 1981, support for the measure has grown. The President has indicated his backing for the measure by including PUHCA repeal in his legislative program for 1985. Moreover, Vice President Bush's Task Group has endorsed repeal as a step towards improving the regulation of the financial services industry. With this level of support, it is appropriate to factor repeal into the Commission's fiscal 1986 planning.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearings of April 17, 1985

Public Utility Holding Company Act

Part b. What impact did OMB have in the Commission's eliminating all twenty positions of the Division of Public Utility Holding Company Regulation?

Answer. The Commission has not eliminated all twenty positions in the Division of Public Utility Holding Company Regulation. As a result of a management study conducted by the Commission's Office of the Executive Director in 1984, the Office of Public Utility Regulation was reorganized and merged into the Division of Investment Management. The staff was reduced by seven positions to reflect a declining workload (the number of filings processed has declined 54% since 1980) and to recognize efficiencies in program management and administration that could be achieved by merging the program into Investment Management. As a result of the study, the staff was reduced to 13 positions.

In preparing the 1986 budget, OMB directed the agency to eliminate funds for the remaining 13 positions because of the expected repeal of the Act in fiscal 1985. However, the Commission will not eliminate the positions unless the Act is repealed and will continue to fully and effectively administer and enforce the Act until its repeal.

Part c. Was this the initial SEC recommendation and position or an OMB directed policy?

Answer. Although the Commission has endorsed repeal of the Public Utility Holding Company Act, the Commission's 1986 budget request to OMB did not assume repeal in fiscal 1985. OMB reflecting the expectation of PUCHA repeal in 1985, directed the agency to delete the funding and positions for the program.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Question 15. Rule Changes

What percentage of the proposed rule changes filed by self-regulatory organizations are acted upon by the Commission within the 90 day period established in the Exchange Act?

Answer. For the period beginning October 1, 1983 through December 31, 1984, self-regulatory organizations filed 416 proposed rule changes with the Commission pursuant to Section 19(b) of the Securities Exchange Act of 1934. Approximately 85 percent were acted on within 90 days of publication in the Federal Register. The remaining 15 percent of the proposed rule changes (for which the self-regulatory organization agreed to an extension of time for Commission action beyond 90 days) generally involved complex or controversial issues requiring the self-regulatory organizations to respond to issues raised by the Commission or the public, and requiring additional time for the Commission to adequately consider and act upon the issues presented.

RESPONSE TO QUESTION OF SENATOR PROXMIRE,

Hearing of April 17, 1985

Question 16. Fees.

Part a. I see from your budget submission that in 1985, the SEC expects to collect 119 percent of its operating expenses from fees and in 1986, the SEC expects to collect 128 percent of its operating expenses from fees.

You point out that in 1986 "the $10 million revenue increase is expected to largely result from a resumption of the historical growth rate in securities transaction volume of 27 percent per annum."

According to the figures you have submitted to us, in 1986 you are asking for a budget appropriation of $107,267,000, which is essentially a budget freeze, while at the same time you estimate the Commission will receive a total of $137,445,000 in fees.

Do you see any correlation between increased fee income and increased workload at the Commission?

Answer. There is a correlation between fee income and Commission workload. A large percentage of the Commission's fee income (a projected 66% in 1986) is generated by fees associated with registrations under the Securities Act of 1933, other filings and reports. An increase in these fees reflects an increase in the registrations, other filings and reports which much be processed by SEC staff. Other Commission fees arise from transactions under the Securities Exchange Act of 1934. (It is these fees which account for 94% of the projected $10 million fee increase in 1986.) Economic recovery and the attendent increase in securities market activity creates more opportunities for fraud and other securities violations, however, it is difficult to correlate these fees with the Commission's actual enforcement and regulatory workload.

Part b. Wouldn't it make sense to plow some of this increase in fee revenue back into the Commission especially since the Commission would still be self-supporting?

Answer. The Commission's proposed budget for 1986 is sufficient for the Commission to discharge its statutory mandate.

This question raises the issue of the relationship between the agency's fee income and its appropriations. To attempt to adjust the Commission's appropriations to its fee income is a difficult proposition and historically ill-advised. Fees will always fluctuate with such factors as the volume of business transactions which may be unrelated to the Commission's budget needs. Considered as a percentage of appropriation, fees have varied widely during the SEC's 50-year history. In 1943, fees amounted to only 3.9% of the agency's appropriation, while in 1984, fees reached 129% of the agency's appropriation. In the past six years alone, fee collections have ranged from a low of 42% of the agency's appropriation in 1978 to a high of 129% of the appropriation in 1984.

Part c. Explain to me why should the Commission be a revenue raiser for the government?

Answer. The Commission should not be a revenue raiser for the government. Current high fees reflect a remarkable level of market activity that will not be sustained over the long run. Fees have fallen short of appropriations in 47 of the SEC's 50 years. In the three years 1969, 1983 and 1984, fees exceeded appropriations by 18%, 10% and 29% respectively. Over the Commission's 50-year history, however, fees have accounted for only 68% of the SEC's appropriations.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE COMMISSIONER

August 12, 1985

The Honorable Christopher J. Dodd
United States Senate
324 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Dodd:

In Chairman Shad's absence, I am enclosing the attached materials in response to the questions which you submitted for the record in connection with the Commission's authorization hearing on April 17, 1985. Each of your questions is repeated, followed by the response.

Sincerely,

Charles C. Cox
Commissioner

Attachment

cc: Chairman Alfonse M. D'Amato

RESPONSE TO QUESTION OF SENATOR DODD

Hearing of April 17, 1985

Question 1. The credit provisions of the Securities Exchange Act of 1934 and the credit restrictions of Regulation T of the Federal Reserve Board were designed to help prevent the excessive use of credit in the securities markets, which had contributed to the collapse of the financial system of the country in 1929. Now the proposed SEC rule relating to the permitted use of mandatory installment payments in connection with the purchase of publicly offered limited partnership interests would overturn prior regulation in the area. I understand that both the industry and the state securities regulators are opposed to this change. Would you please tell us what the Commission rationale is for proposing the change?

Answer. Since 1972, the Board of Governors of the Federal Reserve System ("Board") has taken the interpretive position that a broker-dealer that participates in the public sale of limited partnership interests on an installment basis is "arranging" for the extension of credit in violation of Section 7(c) of the Exchange Act and Regulation T thereunder. The Commission's staff has generally taken a similar position under Section 11(d) of the Exchange Act which prohibits a broker-dealer from extending or arranging for credit in a distribution of a new issue of securities.

In the intervening years, the merits of permitting installment sales in public offerings of limited partnership interests has been intensely debated within the securities industry. On several occasions, most recently in April 1983, the National Association of Securities Dealers, Inc. ("NASD") formally petitioned the Board to re-examine its position, and proposed several conditions designed to protect investors that could apply to any exemption from the prohibition. The NASD argued that lifting the prohibition on installment sales would benefit public investors by permitting them to retain the use of funds not presently needed by the partnership rather than have those funds invested by the partnership. In addition, the NASD noted that the present ability to offer installment sales only in private placements in effect foreclosed participation in those investment opportunities by investors who could not meet the "accredited investor" standard of Regulation D. After extensive consultation between the Board and Commission staff, it appeared that the most efficient way to expose the issue for public scrutiny was for the Commission to propose a rule pursuant to its authority under Section 3(a)(12) of the Exchange Act.

The Commission's rule, which was published for comment in November, 1984 (Release No. 34-21495), would permit installment sales if:

- The securities are registered under the Securities Act of 1933;
- The issuer registers the securities under Section 12(g) of the Exchange Act and the securities remain so registered until the total purchase price of the security is paid; and
- The mandatory installment payments bear a direct relationship to the cash needs and program objectives described in a business development plan disclosed in the registration statement filed with the Commission.

The Commission believed it was important to allow the securities industry and other persons with an interest in this issue to publicly state their views, both positive and negative. The Commission received 124 comment letters, with 57 supporting, and 67 opposing, the Rule. Those in support included the Securities Industry Association and its Limited Partnership and Direct Investment Committee, which is comprised of both small and large broker-dealers, the NASD, fifteen program sponsors and several bar associations, including the American Bar Association. Those opposed included the National Association of Realtors, and its affiliate, the Real Estate Securities and Syndication Institute, which includes persons involved in all aspects of the real estate business, some members of these groups in their individual capacities, the North American Association of Securities Administrators, and Senators Jake Garn and Alphonse D'Amato.

The staff of the Commission is currently in the process of analyzing the comments received. The staff is also exploring the tax implications of the proposal with the staff of the Internal Revenue Service. After the staff has concluded its analysis it will forward a recommendation to the Commission for further action on the proposed Rule.

Question 2. While the Commission has argued that the rule would result in increased investor protection because numerous private offerings which are now exempt from the Securities Act registration provisions would register with the SEC, others have contended strenuously that the rule would have disastrous effects. Because the other view is in such stark contrast, I'd like to present it in considerable detail for your response.

Opponents of the proposed rule argue that there would be an unwarranted expansion of credit in the financial marketplace and widespread use of credit in the form of installment payments by investors purchasing securities which would increase the risk of financial collapse of our economy. Furthermore, they argue that it is unlikely that there will be an increase in public registration because that is a time consuming and costly process. Instead, it is argued that the rule would create unnecessary additional risks for the investing public. They say that small investors, who are the typical investors in publicly offered limited partnerships, may not be able to anticipate future needs and thus may be encouraged to default in making their future payments, especially in times of recession. They say that the use of installment payments will result in increased tax write-offs as a percentage of the investors' cash contributions during the installment period, thereby allowing securities brokers to sell a deeper tax shelter to investors than is presently available in public partnership offerings. It is contended that this will cause issuers of these securities to pay less attention to the economics of the underlying investments and result in a decrease in revenues to the U.S. Treasury since tax write-offs will accelerate with no corresponding increase in the economics of investments. Finally, it is argued that the use of installment payments is likely to contribute to an unrealistic and unstable real estate market due to artificially higher prices being paid for real properties which might be purchased solely for tax reasons.

This is a very bleak view of the consequences of your proposed rule. What is your response to these concerns?

Answer. Each concern cited is addressed below. It should be noted, however, that the staff has not completed its analysis of these concerns and that these responses are preliminary in nature.

The first concern is that the rule would permit an unwarranted expansion of credit in the financial marketplace.

The proponents of the rule argue that installment sales do not contravene any of the purposes enunciated by the Congress when it adopted the credit restrictions, including the prevention of the excessive use of credit for the purchase or carrying of securities. In that regard, they contend that staged payments for interests in the type of direct participation programs covered by the rule (i.e., those where payments bear a direct relationship to the cash needs and program objectives disclosed in the registration statement) do not involve an extension of credit, but instead are more closely analogous to payments for work in process, made when and as the work is performed.

In addition, a prediction that the amount of "credit" extended through staged payments would increase the risk of financial collapse appears highly questionable. As noted in the recent Federal Reserve Board margin study, the ratio of security loans at banks to total bank credit and the ratio of all security loans relative to the aggregate of all credit in the economy have declined substantially on balance over the past 50 years and may account for only a small percentage of each of these broad measures of credit. Therefore, while the Commission will carefully consider concerns over potentially increased investor default and possible adverse effects of those defaults on partnerships, more widespread effects on the economy appear speculative.

Another purpose of the credit restrictions is to prevent excessive speculation in the securities markets. Some commentators pointed out that the sale of direct participation securities is not characterized by fluctuation in securities prices. Program securities are generally purchased as long-term investments since there is no active secondary market.

The second concern is that it is unlikely that there will be an increase in public registration because that is a costly and time consuming process.

Proponents of the rule argue that because installment payments are currently available only in private offerings, many investors are denied the opportunity to participate in such programs although many would like to do so. To the extent there is such investor interest, registration with the Commission would be cost effective.

The third concern is that the rule would expose investors to additional risks; possibility of default of investors on future payments.

Proponents of the rule argue that in 1972 when installment sales in public offerings were first prohibited, there was little regulation of direct participation programs. Since then, the states and the NASD have developed specific regulations to determine the fairness and reasonableness of program offerings. For example, NASD rules and those of most states require broker-dealers selling these securities to make a specific suitability determination for each investor and the broker must have a reasonable basis to believe that the investor has sufficient net worth to sustain the risks inherent in the program. In addition, the Commission has developed additional disclosure and reporting obligations specifically to apply to program offerings. Of course, persons involved in the sale of these securities are fully subject to the antifraud provisions of the federal securities laws.

Finally, installment payments are currently allowed in private placements of securities. The Commission has been informed that currently the number of defaults in making required payments is negligible.

The fourth concern is that the rule will result in increased tax write-offs as a percentage of cash contributions during the installment period, thereby allowing securities brokers to sell a deeper tax shelter to investors than is presently available in public partnership offerings. It is contended that this will cause issuers of securities to pay less attention to the economics of the underlying investments and result in a decrease in revenues to the U.S. Treasury since tax write offs will accelerate with no corresponding increase in the economics of investments.

The Commission does not have the expertise to provide any in depth analysis of the tax implications of its proposed rule. Lawyers experienced in tax matters, however, have advised the IRS and the Commission in a letter in the Commission's public files of their belief that many of these concerns are not well founded. For example, they argue that deeper tax shelters will not be structured because the Internal Revenue

Code ("Code") does not limit the ratio of allowable tax benefits claimed by a limited partner to the amount of cash he contributes to the partnership. Thus, neither the timing (assuming that adequate basis is provided to the limited partners as a result of partnership level borrowings incurred to acquire the property) nor the total amount of tax benefits available to limited partners of a partnership owning depreciable real estate is affected by the timing of limited partners' capital contributions.

These persons also argue that the use of installment sales will not encourage tax shelter promoters to structure abusive transactions because the rule would merely permit a new type of financing without changing the existing tax treatment of limited partnerships. If such abuses should occur, they argue that the Code provides the IRS with substantial weapons to combat non-economic or abusive transactions.

The fifth concern is that the use of installment payments is likely to contribute to an unrealistic and unstable real estate market due to artificially higher prices being paid for real properties which might be purchased solely for tax reasons.

In the same letter referred to above, tax lawyers have advised the IRS and the Commission that to the extent this concern is addressed to tax-motivated overpayments for real estate acquired for syndication, they believe that the Service has substantial weapons (e.g., the Code §6659 penalty for valuation overstatements and the Code §6621(d) increased interest rate on substantial underpayments attributable to tax-motivated transactions) with which to combat overvaluations of real estate intended to generate increased tax benefits. Also, because of the more onerous disclosure, liability and penalty provisions applicable to registered offerings under the 1933 Act, they think that the proposed rule would make it even less likely that overvaluations of real estate would occur than may be the case today.

THE WEALTH EFFECTS OF LITIGATION BY TARGETS: DO INTERESTS DIVERGE IN A MERGE?*

GREGG A. JARRELL
U.S. Securities and Exchange Commission

I. INTRODUCTION

PUBLIC tender offers for control are often resisted by the target's top management.[1] This recalcitrance takes many forms, from newspaper advertisements urging shareholder rejection to more costly legal actions.[2] This paper focuses on litigious target managements, since these serious defensive efforts usually delay considerably the execution of the defendant's tender offer. In some cases the litigious defense forces the sole bidder to withdraw the premium offer, imposing large losses on shareholders. These losses cause many to question whether strenuous legal defense by target management is consistent with their legal duty to maximize shareholder wealth.[3]

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* The views expressed in this article do not necessarily represent those of the SEC or any of its members or employees. This paper was written while I was a Research Fellow with the University of Chicago's Center for the Study of the Economy and the State. I gratefully acknowledge the support and encouragement of George J. Stigler, the Center's director. Michael Bradley provided me with his master sample of tender offers, as well as his invaluable advice and criticism. Helpful comments were also received from F. Easterbrook, C. Friedland, L. Herzel, R. Higgins, P. Pashigian, S. Peltzman, T. Ross, R. Smith, and other participants of the Law and Economics Workshop at the University of Chicago. M. Ryngaert and M. Noether provided expert research assistance; C. Friedland suggested the title.

[1] Many public tender offers follow scuttled merger negotiations between the same firms. Some hypothesize that merging is the lower-cost method of exchanging control, with tender offers resulting only if the negotiators cannot agree privately how to divide the gain from the combination. An analogous problem occurs when disputing parties attempt to avoid the high transaction costs of lawsuits by settling their differences out of court. Refer to John P. Gould, The Economics of Conflict, 2 J. Legal Stud. 279 (1973).

[2] The various defensive tactics are described in Arthur Fleischer, Tender Offers, Defenses, Responses, and Planning (1978); and in Edward R. Aranow, Herbert A. Einhorn, & George Berlstein, Developments in Tender Offers for Corporate Control 193–206 (1977).

[3] See Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981).

[*Journal of Law & Economics*, vol. XXVIII (April 1985)]
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On the other hand, defensive litigation by the target is often followed by rivalrous bidding involving many potential suitors. Indeed, target managers usually justify their defensive efforts by declaring the original bid to be "insufficient." It is also common for target management to drop its litigation in response to a sweetened offer from the initial bidder or to be acquired on friendly, lucrative terms by a "white knight."

Beneficial outcomes such as these offer a possible justification for the target managements' hostile reactions to the initial, lower takeover bids. By playing hard to get, target management may be directly responsible for the handsome returns that takeover auctions can produce.

Observed thwarted takeovers need not refute this shareholder welfare theory. This litigious strategy may be expected to fail sometimes. The sole bidder may be discouraged enough to withdraw its offer. However, this should not happen often if the goal of target management is to increase the takeover price and not to drive away all bids.

It is not easy to assess the ultimate motives of the litigious targets or their opponents by studying their charges and countercharges. In view of the importance of strategic posturing in litigious takeover battles, it is hazardous to base these judgments on their actions and pronouncements during the fray. Distinguishing between bluff and verity is difficult, even after the battles are over.

This paper examines how resistance through litigation affects the wealth of shareholders, averaged over a large number of cases. The focus here is on target litigation as a strategic weapon that benefits shareholders by delaying the execution of the offending offer. This delay increases the likelihood that a higher offer will be made by the original bidder or others. Because target litigation can impose substantial costs on the bidder, its actual or threatened use can induce a higher offer from the bidder in return for settlement.

This study assumes that the many different kinds of target lawsuits represented in my sample are all explained by these strategic considerations. I do not attempt to weed out the obvious cases of entrenched management, even though some of the specific actions by managements of unacquired targets are difficult to reconcile with the shareholder welfare theory. Moreover, the shareholder welfare theory of litigious defense assumes that remaining independent by thwarting the takeover attempt is never a beneficial outcome for target shareholders.[4]

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[4] Although one can conceive of theoretical circumstances that would contradict this fundamental assumption, the evidence presented here and elsewhere strongly supports this generalization. The evidence is that unsuccessful takeover attempts result in the target's stock price dropping nearly to its pre-offer level. Refer to Michael Bradley, Anand Desai, & E. Han Kim, The Rationale behind Inter-Firm Tender Offers: Information or Synergy? 11 J.

The null hypothesis is that the common element in all these cases of litigious takeover defenses is the demand for a higher takeover bid. This hypothesis is rejected if the nonbeneficial outcomes of litigation, such as remaining independent, are sufficiently frequent that target shareholders lose wealth on average from this strategy. The alternative hypothesis is that litigation by target managers reflects a conflict of interest between managers and stockholders.

The empirical section shows that litigating targets are very frequently the beneficiaries of delayed auctions or improved bids by the original suitors. The high frequency of these auctions and the large benefits they produce for target shareholders dominate the forgone losses in the cases where litigation helps to prevent takeovers. Therefore, this evidence prevents us from rejecting the shareholder welfare theory of target litigation.

This finding is important because it suggsts that most target litigation should be viewed as a value-maximizing gamble undertaken by managers in the best interests of their shareholders. Two important qualifications emerge from a closer study of these one hundred cases of litigious takeover defenses. First, most of the cases that are not settled end with the court ruling against the target. Although this fact helps justify our treating target litigation as primarily a tactic of delay, it also leaves us unsure about how often target managers would use legal victory to thwart the takeover completely. Perhaps many target managers capitulate and negotiate a takeover only because the courts refuse to protect them.

Second, many of the twenty-one cases in which the target remains independent are difficult to square with the shareholder welfare theory. The defensive actions appear to have been aimed at driving away the only suitor, even after it became rather clear that no auction would materialize and that the sole suitor was offering the highest value for the target. For many of these cases of "successful" takeover defenses it is apparent that remaining independent was the overriding goal of the defense. It is hard to contend that these are unfortunate outcomes of rational gambles designed to produce takeover auctions. This impression serves to heighten our suspicion that at least some actual takeovers would also have been thwarted if the legal battles had been won by the target managers.

Section II outlines a simple model of tender offers for control and describes rational target litigation. The purpose is to show how target managers can benefit their shareholders in takeover battles, even if the managers have no informational advantage. Section III describes the sam-

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Financial Econ. 183 (1983); and Frank H. Easterbrook & Gregg A. Jarrell, Do Targets Gain from Defeating Tender Offers? 59 N.Y.U. L. Rev. 277 (1984). Also see Figure 7 in this paper.

ple of litigating targets and presents the empirical results, which consist mainly of capital market data covering the contest periods. Section IV concludes the paper and addresses briefly some of the normative questions that arise from this and related research.[5]

II. RATIONAL LITIGATION BY VALUE-MAXIMIZING TARGET MANAGEMENT

Litigation can benefit target shareholders by producing a higher takeover premium, either because the initial bidder raises its bid to avoid further litigation or because the delay produces an auction for the target. This section describes some conditions under which target litigation may be necessary to produce one of these benefits for target shareholders.[6]

Consider a tender offer of P_T per share for a controlling fraction F of the outstanding common stock of a target firm, where the fraction F must be purchased on a pro rata basis from the N_T tendered shares. ($F = N_s/N_T$, where N_s is the number of shares sought by the bidder. Pro rata purchasing results in the acceptance of the same fraction F of the shares from each tendering account.) Assume that the target has a market value under incumbent management of P_0 per share less litigation expenses. That is, an exchange of control is required to increase the value of the target firm. Assume that it is known with certainty that the market value of shares unaccepted by the bidder will be P_E per share if control is transferred to the bidder.

There are two conditions that must be met for the bid to be successful. First, the tender price P_T must exceed the expected value per share of unaccepted shares ($P_T > P_E$). If this were not the case, then noncolluding target shareholders would each hold out to receive P_E per share instead of P_T for their holdings.[7] If enough target shareholders hold out, then the bid will fail. Therefore, the bidder must set $P_T > P_E$ to eliminate this incentive among the target shareholders to free ride on the returns from the takeover.

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[5] These normative issues are addressed in Gregg A. Jarrell & Michael Bradley, The Economic Effects of Federal and State Regulations of Cash Tender Offers, 23 J. Law & Econ. 371 (1980); Frank H. Easterbrook & Daniel R. Fischel, Takeover Bids, Defensive Tactics, and Shareholders' Welfare, 36 Bus. Law 1733 (1981); Sanford J. Grossman & Oliver D. Hart, Disclosure Laws and Takeover Bids, 35 J. Finance 323 (1980).

[6] This model of tender offers is presented by Michael Bradley, Interfirm Tender Offers and the Market for Corporate Control, 54 J. Bus. 345 (1980). A more elegant, but consistent, tender offer model is contained in Sanford J. Grossman & Oliver D. Hart, Takeover Bids, the Free Rider Problem, and the Theory of the Corporation, 11 Bell J. Econ. 42 (1980). Also refer to Harry DeAngelo & Edward M. Rice, Antitakeover Charter Amendments and Stockholder Wealth, 11 J. Financial Econ. 329 (1983). Section 4.1 of DeAngelo & Rice contains a more detailed model of the economics of shareholder responses to tender offers for control.

[7] This free-rider problem in the context of takeover bids creates an incentive for shareholders to allow "dilution" of the minority's ownership rights by the bidder after takeover. This issue is discussed thoroughly in Grossman & Hart, *supra* note 6.

The second condition for a successful bid is that the market value of the two-part offer (P_I) must exceed the value of the next-best alternative bid (P_A). P_I is the expected market price of the target that should prevail after the bid is made but before its execution, assuming that the bid will be successful. The market value of the two-part offer is simply the weighted average of the tender price and the ex post value of unaccepted shares, with the weights being determined by the probability of acceptance of tendered shares. Assuming for simplicity that all shares are expected to be tendered, then P_I equals $(P_T \times F) + [P_E \times (1 - F)]$, where F is the fraction of outstanding shares sought by the bidder.

In our example, the alternative value of the target is P_0 per share, which obtains under incumbent management. If there are no competing bidders that will pay more than P_0, then the initial bidder must outbid only the incumbent management, so that this second condition for a successful bid becomes $P_I > P_0$.

To determine the net gain to the bidder from the takeover, let G be the maximum price the bidder is willing to pay for the target (per target share) absent litigation. G will equal the total synergistic gain divided by the number of target shares plus P_0. Therefore, the bidder will pay at most $(G - L_T)$ for the specialized target, where L_T is the per share value of the target resources expended in litigation. The bidder's net gain (NG_B) from the takeover, given the takeover price P_I, is thus equal to $(G - L_T) - P_I$ per target share.

The net gain to the acquired target, NG_T, is simply the takeover price P_I less the alternative value under incumbent management P_0. That is, $NG_T = P_I - P_0$ per target share.

The Role of Target Management in Delaying the Takeover

The example so far leaves no role for target management. Target shareholders are well informed by assumption, so there is no demand for management to educate their shareholders about the expected values of the important variables entering the valuation equations, such as P_T, P_E, or P_0.

To investigate possible reasons for intervention by target management, let us assume that the delay between the initial offer's announcement and its commencement is a valuable input to the creation of competing bids.[8] This assumption is realistic if the information possessed by the initial bidder about how to revamp the target's operations to produce the returns (*G*) becomes public with the passage of time. If other potential bidders can get this information, then they too can make the improvements. The initial bid identifies the target and enables the potential bidders to study this particular firm. The target management can be expected to subsidize this process in the interests of target shareholders. Given extra information from the target and sufficient time, the other bidders can learn the information possessed by the initial bidder. Under these conditions, the target's next-best alternative offer depends partly on the length of time between the initial offer's announcement and its execution.

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[8] A model relating innovation and takeover activity is presented by Jarrell & Bradley, *supra* note 5.

Prisoner's Dilemma and Rational Target Litigation

If target shareholders are rational and well informed, then one might question whether target managers can benefit their shareholders by actively participating during a contest for corporate control. If delaying execution of the initial bid is expected to benefit target shareholders, because of the potentially public nature of the bidder's information, then why will each shareholder not insist on a tender price that beats the best alternative price that delay would produce (properly discounted)? The answer lies in the Prisoner's Dilemma that is created for noncolluding target shareholders by the typical tender offer. This problem prevents them from holding out for the best takeover price. This Prisoner's Dilemma can in principle be solved by centralizing the tendering decision.

The Prisoner's Dilemma and its implications for joint action by target shareholders is easily demonstrated by an example. Suppose the initial tender offer is $20 per share for 50 percent of the outstanding stock and that the ex post price of unaccepted shares is expected to be $10 if control is transferred. This offer is worth $15 per outstanding share if all outstanding shares are tendered. Assume that a superior offer worth $17 per outstanding share will be available if sufficient shareholders refrain from tendering to the initial bidder.

Centralized tendering would clearly result in target shareholders holding out and maximizing their wealth at $17 per share. Noncollusive target shareholders, however, could fail to maximize their wealth. Each atomistic shareholder facing the initial bid will reason as follows: If I think others will tender, then I should tender to receive $15 instead of $10 per share; if I think others (say 50 percent) will hold out, then I should tender to receive $20 instead of $17 per share. This Prisoner's Dilemma can cause sufficient tenders that control is transferred to the initial bidder, despite the certain availability of a better offer down the road.

For merger decisions, the veto power of target management provides for centralized decision making. The public tender offer, however, can commonly create a Prisoner's Dilemma for diffuse target shareholders. Indeed, it is often advantageous to bidders to design offers that create severe penalties for target shareholders that hold out. Under these conditions litigation by target managers can be the most efficient means of preventing target shareholders from falling victim to the Prisoner's Dilemma. Even if the litigation will likely be lost, target managers may create substantial benefits to their shareholders by postponing the execution of the initial bid.

The Effects of Target Litigation on the Takeover Price

Let us assume that litigation by target management can delay commencement of the tender offer after it has been announced. Litigation delays the initial offer and imposes direct costs on the bidder. The target's suit cannot, however, provide target management with perfect veto power over hostile bids. Eventually, it is assumed, the court will rule in favor of the bidder and allow the bid to proceed. At that time, the target will be acquired at the postleakage alternative value (P_L) less target litigation costs (L_T). Thus, the alternative takeover price after litigation (P_A) equals $P_L - L_T$.

If the initial bidder and the target are perfectly informed about these possible legal actions and consequences, then the initial bid, to be successful, must leave both the bidder and the target with more profit than either could obtain after litigation. That is, the lowest bid acceptable to the target management (P_{LOW}) provides the same profit that can be earned by litigating. Thus, P_{LOW} must equal $P_A - P_0$, or equivalently $P_L - L_T - P_0$. The highest bid acceptable to the bidder (P_{HI}) provides the same profit that can be earned by forcing the target to litigate. Thus, P_{HI} must equal $(G - L_T) - P_A - L_B$, where L_B is bidder litigation costs expressed per target share.

If P_{HI} and P_{LOW} are known with certainty, then the initial bid must lie between these limits. Both parties will avoid the costs of litigation. If the initial bidder and target have sufficiently different expectations about each other's profit after litigation, however, then negotiations will break down and the dispute will be settled by experiment.

This simple model of the range of negotiable takeover prices shows how this range is affected by changing the important assumptions. The higher the alternative takeover price caused by delay, the higher is the initial bid required for success. (The Appendix contains an arithmetic example in Table A1.) Also notice that the target's alternative value after delay is reduced by its litigation costs. This implies that the target's negotiating leverage ex ante depends on the productivity of its litigation. The target, therefore, has incentives to produce the necessary delay at the least cost.

Litigation's value to targets need not be restricted to providing delay and encouraging auctions. If the target can potentially impose large litigation costs on the bidder, then the target should be able to extract higher initial takeover bids. This is true even if no other bidder will offer a takeover premium. The higher are the bidder's litigation expenses required in defense, the higher is the maximum price the bidder will offer ex ante to avoid litigation. (The Appendix contains an arithmetic example of this in Table A2.) This result stems from the assumption that target litigation reduces the bidder's profit by more than it lowers the target's profit. The target's negotiating leverage is limited by the bidder's maximum quasi rents from acquiring this particular target. Before this limit, however, the higher (and more differential) are the bidder's expected litigation costs, the higher will be the bidder's initial offer.

Rational Litigation and Ex Post Bias of Sample Selection

The model shows how actual and threatened target litigation can influence the allocation of the gains from combining these two uniquely suitable firms. Both firms realize that the total gains from takeover are reduced by the summed litigation costs. Therefore, rational negotiators with similar expectations of the costs and consequences of the possible legal actions should be able to reach an agreement that avoids the costs of litigation.

Yet litigation is fairly common, occurring in at least one-third of the public takeover bids for NYSE and ASE targets during the past two decades. The scattered reports on direct litigation costs suggest they are often of significant magnitude. In our model, litigation occurs because the initial bidder's public offer is below the value that target management expects a delayed auction to produce. This low initial bid shows that the bidder and target managements disagree about the postlitigation values of their firms. If they agreed, then the firms would merge or combine through a "friendly" public offer.

Rational litigation occurs when beliefs about postlitigation takeover profits (NG_T and NG_B) differ enough to make resolution worth its cost. The events during litigation should reveal information about NG_T and NG_B, causing the beliefs of the bidder and the target to converge. The model assumes that the initial bidder eventually acquires the target. But a better model would allow information about NG_T and NG_B and information about litigation costs (L_T and L_B) to be produced continuously during litigation. This would provide a theoretical basis for renegotiation, with either the bidder or target giving in.

If the initial bidder grossly undervalues the worth of the target after delay, or underestimates its own litigation costs, then the delay should result in a substantial increase in the bidder's offer or in alternative bids from others. These "auction" outcomes should always produce significantly higher takeover premiums for the targets.

Alternatively, if the target is too optimistic about the takeover price that a delay will produce, then events during litigation should force the target management to lower its asking takeover price. If the passage of much time produces no auction, then our model predicts that target management will eventually allow a takeover at some price exceeding the target's value under incumbent management.

The sole suitor can be expected to drop out if during litigation its expected net returns from eventual takeover cannot justify the marginal costs of continued litigation. For example, the target might reveal unexpected legal prowess in imposing direct legal costs on the bidder, causing the bidder to drop out to avoid future legal costs.[9] If the target persists in litigating despite its continued failure to attract alternative offers, the risk increases of losing the only outstanding offer. The sole bidder's exit will reduce the target's value to that under incumbent management.[10] As the continued delay produces no superior offers, it becomes harder to justify litigious obstruction by target management as an effort to enhance their shareholders' wealth.

III. EMPIRICAL RESULTS

The Sample of Litigious Targets

The sample of litigious targets was gathered by searching for lawsuits filed by targets in response to public takeover attempts. The Lexis tape of legal decisions provided the main source of information. Many types of legal actions are represented, including charges of fraud, antitrust violations, and violations of state or federal tender offer regulations. The target generally files its lawsuit(s) within a few days of the first public offer and always seeks to obtain an injunction quickly to prevent the offer from proceeding. Although some cases are dropped before decisions can reveal the legal merit of the target's charges, most of the decisions apparently rule against the target. It is rare, for example, for the target to obtain a permanent injunction. The target usually succeeds in delaying considerably the hostile takeover attempt, according to these cases. But the usual outcome of the fully contested cases appears to favor the bidders, with the courts eventually allowing the tender offers to proceed.

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[9] The delay could also conceivably cause the bidder and the target to alter their expectations of the gain from the takeover. If the bidder increases its estimate of G, then it is more likely to sweeten the bid to forestall further litigation. Conversely, if the bidder lowers its estimate of G, then it might withdraw, since lowering the bid will not avoid litigation unless the target's beliefs change also.

[10] It might be assumed that incumbent management learns the initial bidder's information and can implement the improved strategy, eliminating the necessity of a takeover to produce the gain G. This might partly rationalize defenses that deliberately thwart takeovers or defenses that delay despite the lack of alternative outside bidders. However, the empirical implication of this "rational rejection" theory is that the value of the targets that fight off takeovers increase to exceed the respective values of the rejected bids. The empirical evidence available for NYSE and ASE firms contradicts this implication. See Bradley, Desai, & Kim, *supra* note 4.

The search via Lexis produced 103 NYSE or ASE litigious targets. The *Wall Street Journal* reported over a dozen stories for each litigious takeover contest. Chronological summaries of each contest were collected, and for each case we determined five critical event dates. Each target was assigned a date of first offer (*DO*) and of target suit filed (*DS*). Each successful (acquired) target was assigned a date of execution of the offer (*DE*). Targets that were offered either a substantially higher offer by the same bidder (a sweetener) or a competing offer from another bid were each assigned a date indicating the start of the auction (*DA*). Finally, unsuccessful (unacquired) targets were assigned a date that the last bidder dropped out (*DD*).

Stock return data were obtained from the University of Chicago's Center for Research in Security Prices (CRSP) tapes, specifically the "Scholes's Daily Excess (Beta) Returns" file. This tape provides net-of-market (risk-adjusted) daily returns for NYSE and ASE firms from 1962 to the present. A total of eighty-nine litigious targets have sufficient data on the CRSP tape to be used in the empirical tests.[11]

Table 1 compares the incidence of auctions between our sample of litigious targets and the "control" sample of noncontested public takeover bids from Bradley, Desai, and Kim.[12] Two observations deserve mention. First, the data show that target litigation is quite common, occurring in at least one-third of the public takeover contests for NYSE and ASE firms since 1962. Second, the frequency of auction-style contests is much greater for the litigious targets. Two-thirds of the litigious targets were acquired after auctions, compared with about 11 percent of the

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[11] The published studies of tender offers exclude many of our target firms because of the lengthy takeover contests and the chaotic series of events that the legal battles usually create. Only 20 percent of the litigious targets that were acquired had execution dates less than thirty trading days from the first offer date. Over half of the acquired litigious targets had execution dates greater than sixty trading days from the first offer date. The sample of litigious targets (with CUSIP numbers), original suitors, outcomes of takeover contests, and five event dates for each contest are available from the author on request.

[12] Michael Bradley, Anand Desai, & E. Han Kim, Specialized Resources and Competition in the Market for Corporate Control (working paper, Univ. Michigan, Grad. School Business Admin. 1982).

TABLE 1

FREQUENCY OF AUCTIONS FOR LITIGIOUS AND NONLITIGIOUS TAKEOVER TARGETS

	LITIGIOUS TARGETS*		NONLITIGIOUS TARGETS†	
	Number	Percent	Number	Percent
Auction	61	62.2	19	10.7
Single bid	37	37.8	178	89.3
Total	98	100.0	197	100.0

* These data include nine litigious targets that have insufficient stock returns data to be included in the stock return analyses.

† Michael Bradley, Anand Desai, Han Kim, The Rationale behind Inter-Firm Tender Offers: Information or Synergy? 11 J. Financial Econ. 183 (1983), report that there are forty-eight multiple-bidder events out of a total of 183 offers. Most of these multiple-bidder cases involve litigious targets. Their sample includes only "matched" takeover cases, with both the bidder and target having sufficient stock returns data. Our survey included the other nonmatched tender offers that Bradley has in his master data base, which is why the total sample of nonlitigious targets here exceeds 183.

nonlitigious targets. The auctions for litigious targets usually involve competing bidders (80 percent of total auctions). Moreover, all but two auctions for nonlitigious targets followed well-publicized opposition to the initial bid by target management.[13]

Passive target managements, therefore, were involved in a negligible number of auction-style contests, according to these data on NYSE and ASE firms. Target litigation (or public opposition) and auction-style takeovers appear to be closely related phenomena, with the probability of an auction given neutral (passive) target management being quite low.

The Returns to Litigious Targets

The eighty-nine targets with sufficient CRSP data are grouped into three equal-weighted portfolios. The time series of daily returns for each target is aligned so that time $t = 0$ is the first offer date. The daily average excess returns for each portfolio are used to construct an abnormal performance index (API). The API equals one as of ninety-nine trading days before the first offer, and is compounded to earn the daily average excess return of the particular portfolio.[14]

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[13] The master sample of public tender offers from 1962 to 1978 compiled by Bradley at the University of Michigan documents the reactions of target management as opposing, neutral, or favoring the offer. There are twenty-four cases of opposing management with sufficient CRSP daily returns data; seventeen involve auctions and acquisitions, three are unsuccessful with no auctions, and four are successful with no auctions. The returns to the seventeen "mild-opposition auction" cases are presented in Figure 6. The auctions for these nonlitigious opposing targets all conclude within thirty trading days of the first offer, unlike the more delayed auctions for the litigious targets.

Figure 1 plots the APIs from $t = -80$ to $t = 100$ for the portfolios containing all targets, successful (acquired) targets, and unsuccessful (unacquired) targets, respectively. Figure 2 plots the cumulative frequency of the five event periods, the intervals in trading days from the offer date to the respective event dates. For example, the curve in Figure 2 labeled "Suit" shows that 76 percent of the litigious targets had filed suit against the initial bidder within ten trading days from their respective offer dates (when $t = 0$). Only 27 percent of the fifty-nine auction targets had received their second offer within ten trading days from the first offers. (Refer to the curve labeled "Auction.") Almost 33 percent of the twenty-one unacquired targets had the last bidder drop out after one hundred days from their first offer dates. (Refer to the curve labeled "Drop-Bid.")

The initial mean tender premium is about 31 percent and does not differ much between targets that are acquired and those that are not acquired. Compared with nonlitigious public takeovers, the first offers in litigious cases yield a nearly identical mean premium.[15] The cumulative returns to portfolios of both successful and unsuccessful litigious targets is positive over the ten trading days after the first offer, during which interval seventy-six percent of the targets publicly announced the filing of their suits. However, the unsuccessful target portfolio, after earning positive excess returns until $t = 6$, has its API turn down afterward as the market responds to the few early withdrawn bids and anticipates future bidder withdrawals. By $t = 100$ the API for unsuccessful targets has fallen from a peak of 1.36 to 1.09, and 33 percent of the twenty-one unacquired targets still have outstanding the initial offers for them.

Despite this dismal performance by the portfolio of unacquired targets, the successful targets perform sufficiently well after the first offer that the portfolio of all litigious targets has a nearly flat API. Apparently, the good news received by the numerous successful targets after the first offer

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[14] To review these recent developments in finance theory and application, see Eugene F. Fama & Merton H. Miller, The Theory of Finance (1972); Eugene F. Fama, Foundations of Finance (1976); Eugene F. Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. Finance 383 (1970); Michael C. Jensen, Capital Markets: Theory and Evidence, 3 Bell J. Econ. 357 (1972); G. William Schwert, Using Financial Data to Measure Effects of Regulation, 24 J. Law & Econ. 121 (1981). The abnormal performance index (API) is developed in detail in Thomas E. Copeland & J. Fred Weston, Financial Theory and Corporate Policy 325 (2d ed. 1983).

[15] The mean takeover premium, as measured using a very similar measure to the API, is 32 percent as reported in Bradley, Desai, & Kim, *supra* note 13. Takeovers after 1970 involve much higher premiums than takeovers before 1970 (see Jarrell & Bradley, *supra* note 5), but the Bradley, Desai, & Kim sample contains a chronological distribution of offers roughly similar to our sample of litigious targets.

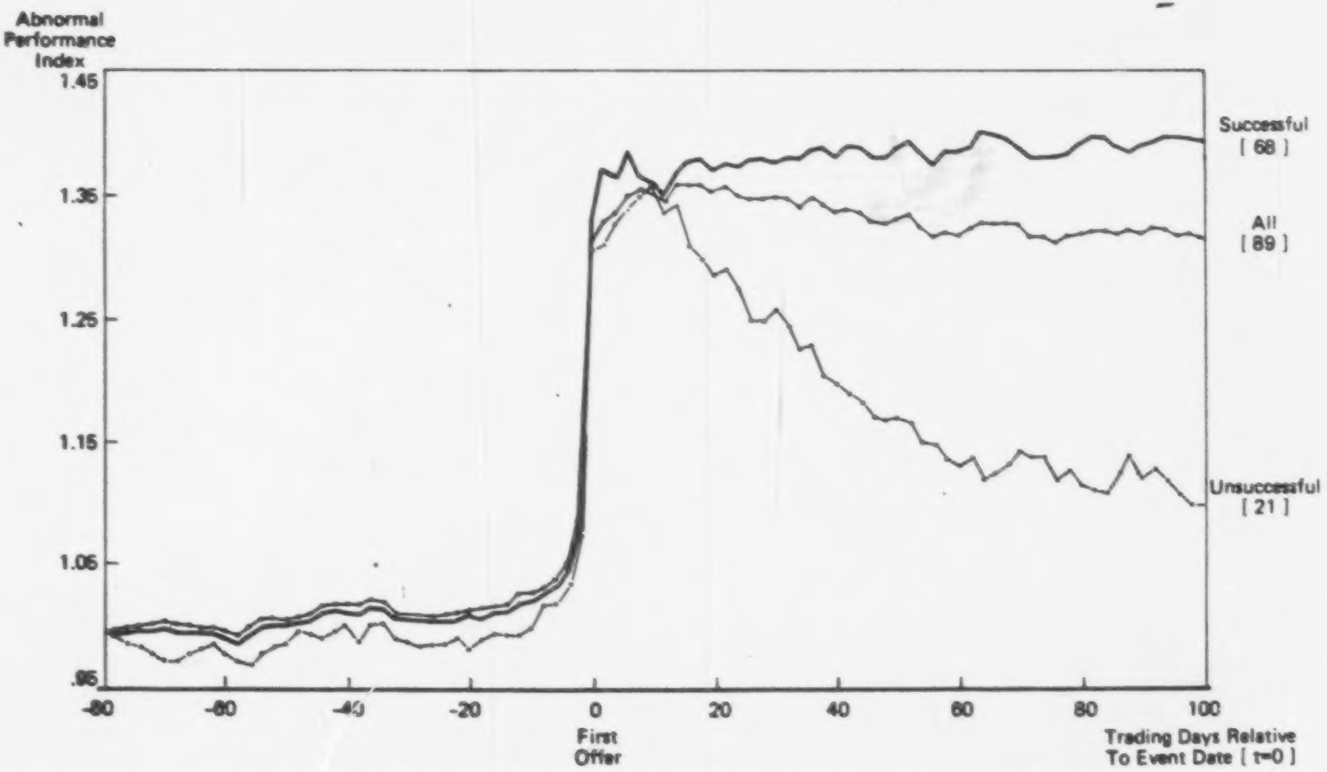

FIGURE 1.—The APIs for acquired, unacquired, and litigious targets relative to the first offer date

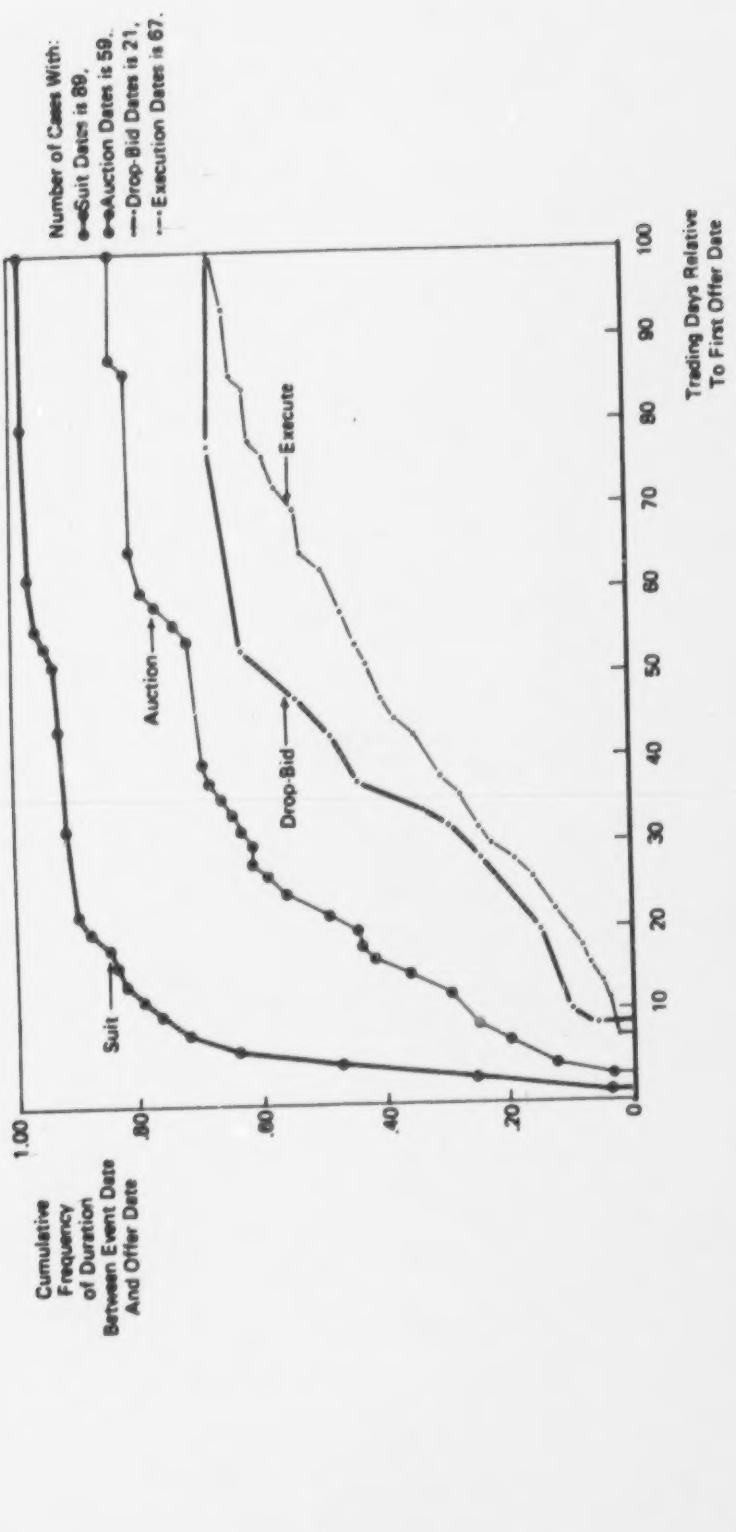

FIGURE 2.—The cumulative frequency of durations between first offer date and other event dates

compensates for the bad news received by the unacquired targets. Indeed, the API for the "All" portfolio looks nearly identical to that for a large sample of successfully acquired, nonresisting targets. (Table 2 presents cumulative abnormal returns in percentages for the three portfolios over various ten-day and five-day periods from $t = -29$ to $t = 60$, along with the relevant cumulative abnormal return [CAR] standard errors and cumulative relative frequencies, in percentages for the three event periods defined in note 1. This information is essentially the same as that contained in Figures 1 and 2.)

The Capital Market Effects of Target Lawsuits

To measure the capital market's reaction to the public announcement of target litigation, we now define $t = 0$ to be the target suit date and compute the cumulative excess returns to the various portfolios of litigious targets. Table 3 presents the cumulative abnormal returns for all intervals between $t = 0$ (date of suit) and $t = 4$. These portfolios exclude all litigious targets that experience other notable events, such as auction starts or bid withdrawals, within four trading days after the suit date. Table 3 shows that all portfolios lose about .45 percent on the suit date, with the standard error for the entire portfolio being .31 percent. If one presumes the market evaluates efficiently the future consequences of target suits on the announcement day, then these portfolio losses might constitute (rather weak) evidence that the lawsuit is on average bad news for the targets. The market's reaction on the suit date ($t = 0$) does not distinguish the different outcomes for the two portfolios (successful and unsuccessful), but rather devalues both portfolios slightly.

Over the four trading days following the suit date, the performance of the successful targets diverges from that of the unsuccessful targets. Indeed, the unacquired targets' portfolio loses 3.4 percent over the four-day interval, while the acquired targets' portfolio gains just over 1 percent from $t = 1$ to $t = 4$, after losing .46 percent on $t = 0$. Apparently the capital market begins to distinguish the beneficial from the harmful defenses within a few short days after the targets file the suits.

The Targets' Returns from Auctions

Figure 3 plots separate APIs for successful auction and successful nonauction targets. The auction portfolio receives a significantly lower initial premium (27 percent) than does the portfolio of single bid targets (41 percent). The lack of auctions for this latter group could be caused in part by the higher initial premiums, which would deter potential competition from other bidders. The API for the fifteen nonauction targets is

TABLE 2

CUMULATIVE ABNORMAL RETURN (CAR) OVER VARIOUS INTERVALS FOR PORTFOLIOS OF LITIGIOUS TARGETS, CENTERED ON FIRST OFFER DATE

	Trading Day Intervals Relative to First Offer Date											CAR Standard Error*	
Portfolio or Event Period†	−29 to −20	−19 to −10	−9 to −5	−4 to 0	1 to 5	6 to 10	11 to 20	21 to 30	31 to 40	41 to 50	51 to 60	5 days	10 days
CAR all (*N* = 89)	.12	1.41	1.94‡	24.48‡	2.23‡	1.01	−.05	−.37	−.90	−.14	−1.13	.60	.85
CAR successful (*N* = 68)	.27	1.32	1.81‡	23.52‡	2.09‡	1.36	1.64	.24	.31	.58	−.24	.71	1.01
Cumulative percentage *PE*	0	0	0	0	0	1.5	9.0	22.4	29.9	38.8	46.3	. . .	. . .
CAR auction (*N* = 53)	.82	.75	1.39	24.33‡	2.76‡	1.42	1.00	.55	1.50	.42	.74	.82	1.15
Cumulative percentage *PA*	0	0	0	0	11.9	27.1	44.1	61.0	69.5	69.5	76.3	. . .	. . .
CAR unsuccessful (*N* = 21)	−.35	1.67	2.38‡	27.81‡	2.52‡	−.14	−5.46‡	−2.29	−4.64‡	−2.25	−3.51‡	1.09	1.54
Cumulative percentage *PD*	0	0	0	0	0	9.5	14.3	23.8	42.9	52.4	52.4	. . .	. . .

* Standard errors of daily excess return in percentages for each of the portfolios are .269 for all, .318 for successful, .365 for auction, and .487 for unsuccessful.

† The three event periods are defined as follows: *PE* is the interval in trading days between first offer and execution; *PA* is the interval in trading days between first offer and the start of an auction; *PD* is the interval in trading days.

‡ Denotes that the CAR is larger in absolute value than twice its standard error.

TABLE 3

CAR FOR VARIOUS INTERVALS (up to Five Days) FOLLOWING TARGET SUIT DATE (Sample Excludes Confounding Events)

	INTERVAL IN TRADING DAYS RELATIVE TO SUIT DATES					STANDARD ERROR DAILY EXCESS RETURN (%)
Portfolio (*N*)	0	0 to 1	0 to 2	0 to 3	0 to 4	
All (71)	−.447	−.030	−.050	.134	−.311	.311
Successful (55)	−.457	.263	.096	.643	.551	.368
Unsuccessful (16)	−.408	−1.051	−.521	−1.693	−3.371*	.524
Auction (40)	−.419	.770	.009	.831	.593	.476
Single (15)	−.521	−1.063	.382	.072	.361	.587

NOTE.—Sample excludes firms with confounding events occurring on or within four days following the suit date. Other events include first offers, auction starts, offers executed, and last bidder drops out.

* Denotes that the CAR in absolute value is greater than twice the relevant standard error.

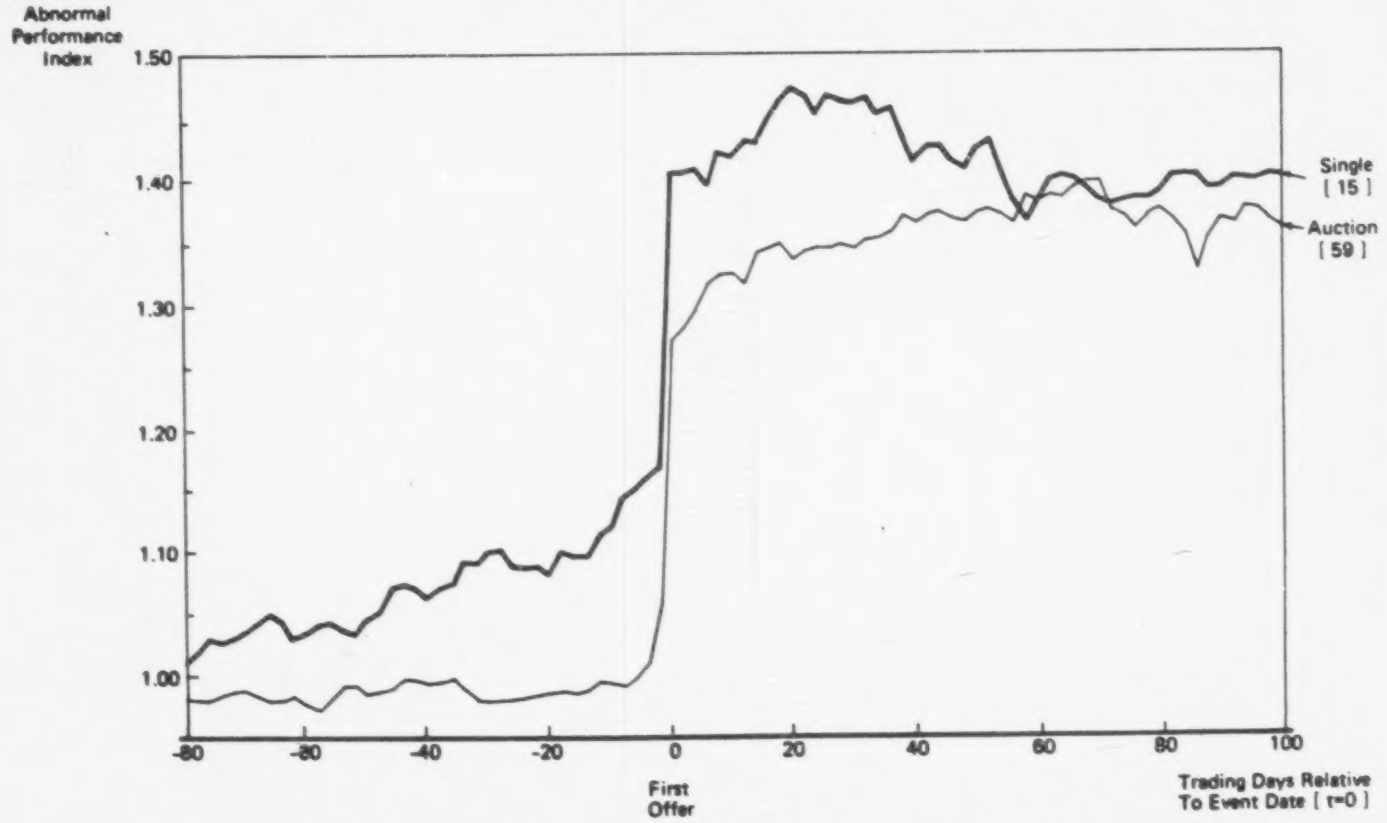

FIGURE 3.—The APIs for auction and nonauction acquired litigious targets, relative to the first offer date

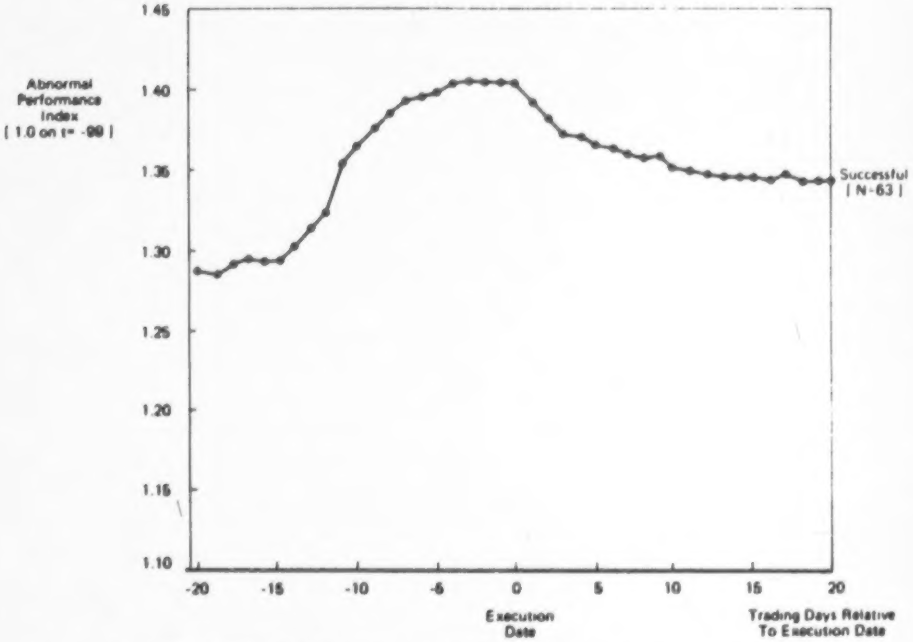

FIGURE 4.—The API for acquired targets, relative to execution date

rather volatile because of the small sample size, and the effect of executions is to reduce the API to 1.37 by $t = 100$.

The auction portfolio shows a continued increase in its API, amounting to a cumulative return of about 15 percent between the date of first offer and $t = 100$. The forty-nine auction announcements for the fifty-three firms cause this increase, and the positive returns from auctions dominate the negative returns caused by executions. Figure 4, which plots the API for all successful targets, with $t = 0$ being the date of execution, shows that the execution of the typical offer causes a decline of almost 5 percent. This 5 percent devaluation reflects the two-part nature of the takeover offers, which leave the ex post value of minority target shares below the interim market price (P_I). Therefore, the mean return from auctions is between 15 and 20 percent, according to Figure 3.

Another method for measuring the mean return from auctions is to form a portfolio of auction targets and set $t = 0$ on the announcement of the auction. Figure 5 plots this API for the fifty-two auction targets. The bar graph indicates the absolute frequency of first-offer dates relative to the auction date ($t = 0$). The API rises prior to $t = -2$ as these first offers are announced for targets in the portfolio. The auction effect occurs from $t = -2$ to $t = 0$, during which interval the auction portfolio earns about 17 percent, even though all first offers have been announced by then.

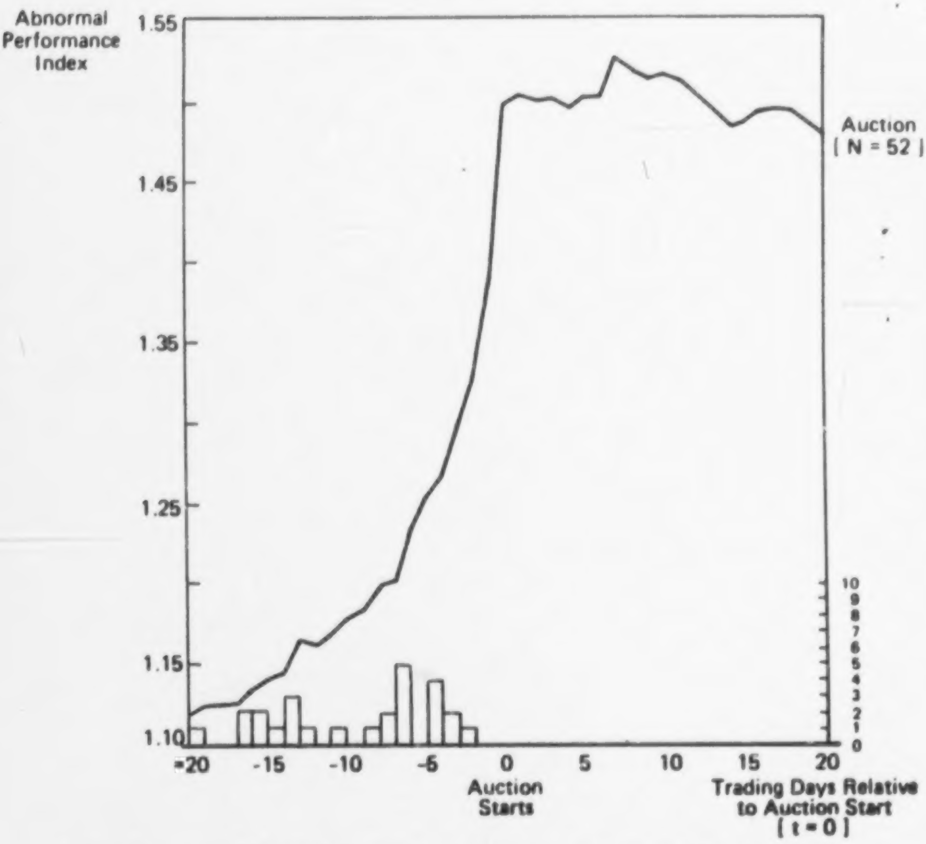

FIGURE 5.—The API for auction acquired targets, relative to date auction starts

Therefore, this evidence is that auctions are quite lucrative for targets. After receiving about 27 percent from the first offer, the auction portfolio earns an additional 17 percent mean premium over the ensuing period as the auctions materialize.

Another estimate of the returns to auctions is provided by the sample of seventeen nonlitigious targets. In these cases target management opposed the initial offer through means short of litigation, such as recommending rejection through newspaper advertisements. Figure 6 plots the API for these nonlitigious auction targets relative to the first-offer date. The auctions for these targets are all announced within thirty trading days from the first-offer date, and all of the offers are executed before $t = 100$. I make sure that no first-offer announcements were dated beyond $t = 0$.[16]

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[16] For example, if just before the tender offer announcement the NYSE stops trading in the target's shares for a short period, $t = 0$ is set at the end of the stop-trading period.

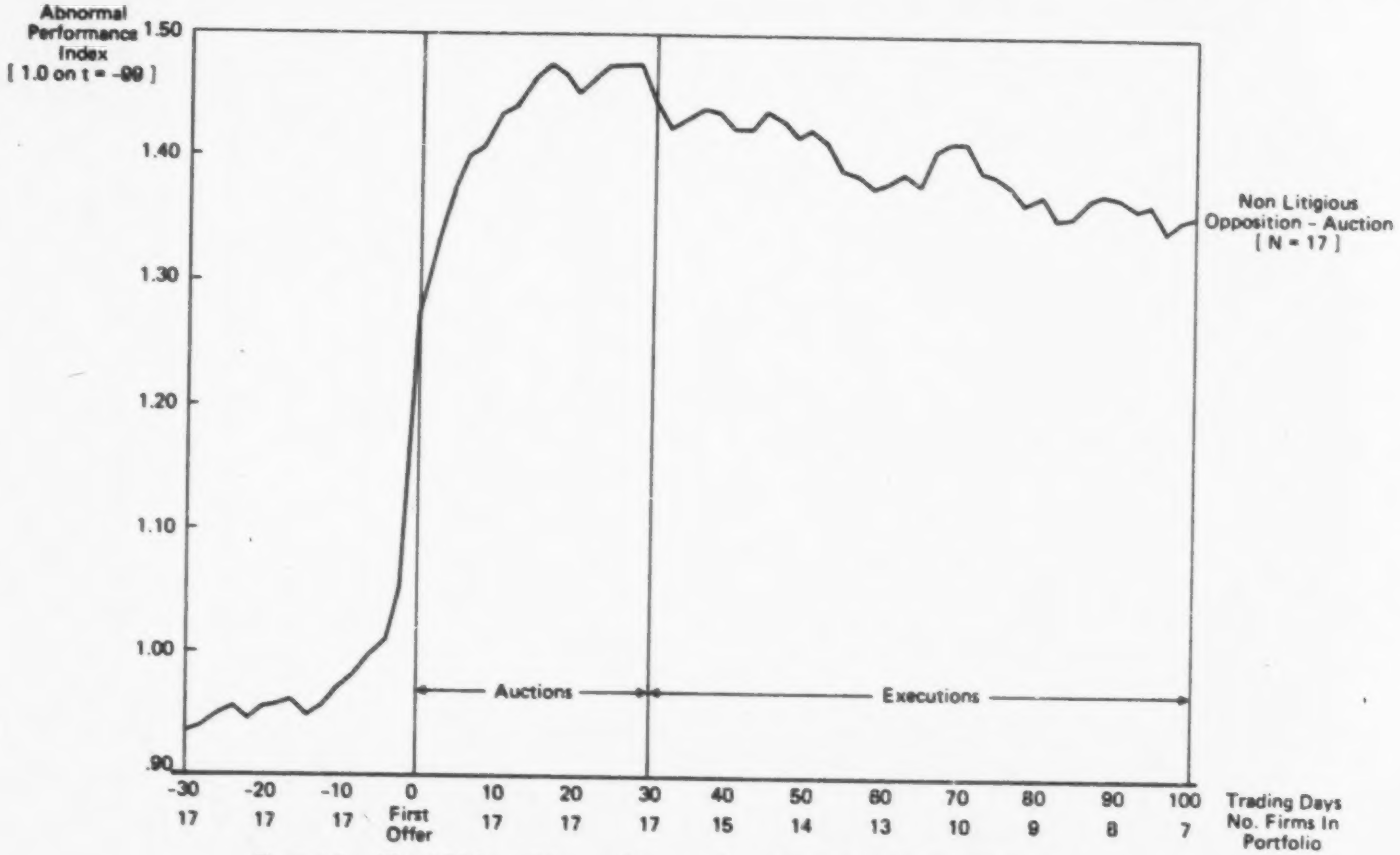

Figure 6.—The API for mild-opposition auction targets, relative to first offer date

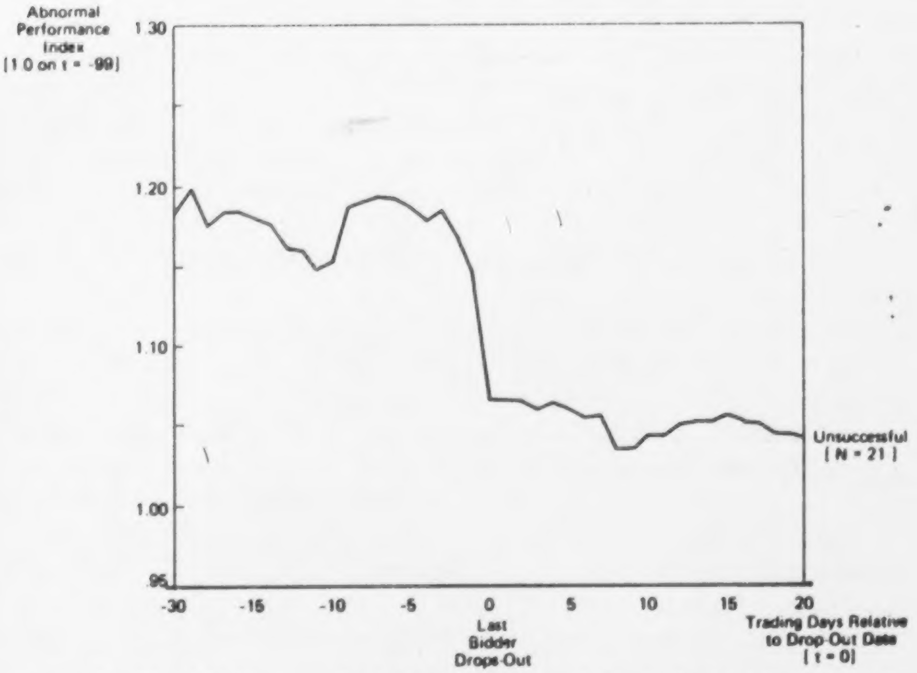

FIGURE 7.—The API for unacquired litigious targets, relative to date bidder drops out

The effect of auctions for these nonlitigious targets is to increase the portfolio value by about 17–21 percent, from $t = 0$ to $t = 30$. (Beyond $t = 30$, the mean devaluation from the offers' executions is about 10 percent.) This return to auctions for nonlitigious targets is quite similar to that for the litigious targets. The auctions follow first offers with much less delay on average for the nonlitigious targets, but the mean return during the announcement of the auctions confirms that these are very beneficial outcomes for target shareholders.

The Returns to Unsuccessful Targets

Figure 1 shows clearly the disastrous wealth consequences for target shareholders when litigation results in the single suitor's withdrawing its outstanding takeover offer. This resistance prevented the target shareholders from receiving the 32 percent mean premium of the initial offer, and it cost them the direct expenses of the litigation. (Figure 7 shows the negative returns to the portfolio of unsuccessful targets centered on the date the sole bidder announced the withdrawal of its bid.) If remaining independent was the true objective of target management, then by this evidence their actions were not in the best interests of their shareholders.

If this outcome is the unfortunate result of an attempt to receive a higher takeover premium, then it is not necessarily counter to the interest of target shareholders.

The conclusion that entrenched management put their interests ahead of shareholders is strengthened by a closer examination of these twenty-one cases. The sole bidder typically withdraws the offer only after the target demonstrates its ability to impose considerable delay and expense. The bidder usually makes explicit last-ditch efforts to get target management to relent.

Although for these twenty-one cases it is hard to justify management's actions, the returns from auctions are sufficiently lucrative in the other cases to caution us about judging too harshly those that remain independent. Moreover, some of these auctions do not materialize until long after the initial bid was made. There remains the possibility that rational strategic considerations can justify managements' stubborn adherence to demands for higher takeover premiums. The acquired targets that received only one offer have higher returns from the first offer than do the unacquired targets. Many of these acquired targets dropped litigation after a short time and accepted the offer, which perhaps suggests that the unacquired targets' vigorous opposition might have been dropped had the premium been higher.

Turnover of Top Management for Targets That Thwart Takeovers

In the light of the opportunity losses to the shareholders of these unacquired targets, I investigate the turnover among the top management and the board of directors of each firm over the years following the defeated takeover attempt. Table 4 summarizes these turnover measures for each unacquired litigious target. The "natural" rate of turnover is probably significantly less than 50 percent over a three-year period. Thus a turnover rate above 50 percent can be considered unusually high.[17] By this criterion, nine of the twenty unacquired targets experienced high turnover following the takeover attempt, with Sterndent, Sunshine Mining, and ABC Companies showing the highest turnovers. Two of the firms were merged into other firms, and all but one of the remaining nine firms experienced turnover rates that could be considered normal.

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[17] Recent research by Robert Comment lends some support to the assumption that the rate of turnover is significantly less than 50 percent over a three-year period for senior management and directors. Comment finds that among the chairmen, presidents, and chief executive officers of 2,700 firms (traced over 1975–80) the normal turnover rate is about 25 percent. Robert Comment, Evidence on Management Entrenchment and Turnover in the Contest of a Market for Corporate Control (August 1984) (working paper, Univ. Michigan, Grad. School Bus. Admin.).

TABLE 4
Staff and Director Turnover during Three Years following Thwarted Takeover

Company	Drop out Date	Senior Staff		Directors*	
		Lost	Gained	Lost	Gained
Federal Paper Book	4/10/68	3/132	5/15	0/6	2/8
ABC Companies	7/17/68	6/13	6/13	5/10	4/9
B. F. Goodrich	8/12/69	3/15	8/20	2/10	1/9
Spartan Corp	1/27/71	nc	nc	nc	nc
General Host Corp	4/24/73	0/6	5/11	2/6	2/6
Sonesta Intn'l Hotels	7/10/73	1/6	2/7	0/5	2/7
Great Atlantic & Pacific Tea	7/26/73	8/14	5/11	1/6	5/19
Hastings Manufacturing	12/10/73	2/8	4/10	1/33	1/3
Sterndent Corp.	5/2/75	4/8	6/10	9/5†	11/7
Unitek	6/8/76	m‡	m	m	m
Pargas, Inc.	3/21/77	4/9	5/10	2/7	2/7
Universal Leaf Tobacco	6/10/77	4/17	3/16	3/7	5/9
Marshall Field	2/22/78	2/7	5/10	1/9	5/13
McGraw Hill	2/26/79	6/27	10/81	2/12	0/10
Sunshine Mining	3/27/79	4/6	3/5	4/2	6/4
Ludlow Corp.	5/4/79	m	m	m	m
Woolworth, Inc.	5/30/79	14/24	7/17	4/10	3/9
Harnischfeger	11/30/79	2/9	2/9	1/7	2/8
Kennecott	1/29/81§	2/18	1/17		
Grumman Corp	11/16/81	nc	nc	nc	nc

Note.—m = merged into another firm; nc = no change.

* Number of directors include only those additional to those also on senior staff. In all cases, numerator refers to number of staff (directors) who left (were hired by) firm. Denominator refers to total number in year of drop for losses and three years later for gain.

† When numerator exceeds denominator, it indicates that specific individuals were both hired and dropped within three-year period studied.

‡ Merged into Bristol-Myers April 1978.

§ Acquired by Tyco Labs 9/1/81.

This tally shows that about half of these recalcitrant targets had at least minor shakeups in the top ranks of management. Without a control group, it is hard to know how abnormally large are these turnover rates. The most one can infer from these data is that turnover is probably unusually high for half of the firms and about normal for the other half. The data do not reveal wholesale turnover following target management's defeat of the takeover, even though with hindsight this resistance must be among the worst decisions for their shareholders that these managements had ever made.

CONCLUSION

The empirical investigation of the wealth effects of litigious takeover defenses by target management yields several results consistent with the shareholder welfare theory. Over 75 percent of the one hundred litigious targets are acquired, and their eventual acquisition is, on average, at a significantly higher takeover premium. Nearly 80 percent of the acquired targets benefit from lively auctions involving competing bidders or from substantially sweetened offers from the sole suitors. The typical auction provides an additional 17 percentage points to the already large initial takeover premium. Moreover, the frequency of auctions among litigious targets is much larger than that for nonlitigious targets. Indeed, among those NYSE and ASE targets whose managements remained neutral, there have been only a handful of auctions since 1962.

The targets that defeat the takeover attempt by vigorous litigation lose the entire takeover premium. Indeed, it is hard to find any case where remaining independent was beneficial to target shareholders, as measured by stock returns. But the large returns to auctions and the high frequency of auctions among litigious targets at least suggest that remaining independent is an unintended and unfortunate outcome of the target's response to the initial hostile tender offer. Target management seems to take a value-maximizing gamble by litigating. The winners receive auctions and the losers forgo the initially offered premium. The evidence here shows that the actual gains from auctions compensate target shareholders for the losses of thwarted takeovers, on average.

This interpretation of the data is comforting for several reasons. First, the ligitious defense to public takeover bids occurs frequently—about one-third of the time. If a litigious defense usually signals entrenched target management, then one must conclude that the interests of target managers and their shareholders diverge substantially and frequently. This would be a powerful indictment of the corporate system that separates ownership and control.

Second, it is puzzling that so many entrenched target managements would deny their shareholders these takeover premiums just to protect their tenure. Why cannot side payments resolve this conflict between target managers and their shareholders? (Are "golden parachutes" and other kinds of change-of-control compensation a response to this agency problem?) It is comforting to interpret litigious target defenses as sensible gambles, rather than shameful self-dealing by managers.

Despite this evidence, there remains an obstacle to concluding that target litigation is generally a value-maximizing gamble. Because the courts usually rule against the target and eventually allow most offers to proceed, it remains possible that many of the acquired targets' managers might have thwarted the takeover if the courts gave target management veto power. Perhaps many target managements give in only because the courts force them to.

Also, some target lawsuits seem designed to prevent any takeover rather than to elicit a better offer. Antitrust suits that would preclude acquisitions by large classes of bidders if successful are an example.

Nonetheless, without separating the more incriminating types of lawsuits from the sample, the high frequency of beneficial outcomes (lucrative auctions) makes it impossible to refute the shareholder welfare theory with this evidence. Therefore, simply observing a litigious defense is an insufficient basis for claiming that target management is acting counter to its shareholders' best interests. It may be justified as a strategic effort to extract a higher takeover premium. This is consistent with the well-supported conclusion that deliberately blocking all takeover attempts is very harmful to target shareholders.

Finally, it is important to recognize that this conclusion—that litigious defenses can be beneficial to target shareholders—does not imply that such actions enhance social welfare. Indeed, the opposite is more likely to be true, because litigious defenses redistribute some of the gains from corporate combinations from acquirers to the targets. This redistribution is analogous to a tax on acquirers. Under the assumption that sunk investments by the acquirers produce the bulk of the gains to takeovers, this tax will deter future investments in this valuable acquisition-oriented information. Although litigious defenses (and regulations) that encourage auction takeover contests can benefit existing target shareholders, these gains must come at the expense of the shareholders of the acquiring firm and the firms that would have been targets if takeovers were cheaper. The evidence here, therefore, can be consistent with the normative position that social welfare is maximized by a rule of passivity by target managers.

APPENDIX

Definitions of the terms and the equations required to demonstrate arithmetically how delay and costly litigation affects the range of negotiable takeover prices

are shown below. Section A lists the general definitions that describe the pre-offer value of the target, the terms and value of the tender offer, and the distribution of gains between the bidder and target. Section B assumes the offer is fully subscribed, that acceptance is pro rata, and that there is no litigation. Subsection B2 lists the additional definitions where I allow for target litigation that imposes costs on both the bidder and the target. The range of negotiable prices follows from the preceding equations. Tables A1 and A2 contain the examples.

TABLE A1

RANGE OF NEGOTIABLE PRICES FOR DIFFERENT VALUES OF P_A, THE POSTDELAY VALUE OF THE TARGET (Net of Litigation Costs L_T)

	P_A VALUES				
	10	11	12	13	14
Target's mimimum asked price (P_{LOW})	10	11	12	13	14
Bidder's maximum bid price (P_{HI})	12	13	14	15	16
Midpoint of range ($[P_{\text{LOW}} + P_{\text{HI}}] \div 2$)	11	12	13	14	15

NOTE.—This example shows that as the postdelay takeover price of the target is increased, the minimum asking and maximum bid price range increases directly. This example assumes perfect knowledge, 100 percent tendering, and fixed litigation costs of $1 per target share for each party. The prices are expressed on a pro rata basis per target share, assuming 100 percent tendering. Definitions:

$P_T = 20$
$P_E = P_0 = 10$
$F = 50$ percent
$P_I = 15 = .5\,(20) + .5\,(10)$
$G = 20$
$NG_T = P_I - P_0 = 5$
$NG_B = G - P_I = 5$
$L_T = L_B = 1$
$NG_{TS} = P_A - 10$
$NG_{BS} = 18 - P_A$
$P_{\text{LOW}} = P_A$
$P_{\text{HI}} = P_A + 2$

TABLE A2

RANGE OF NEGOTIABLE PRICES FOR INCREASINGLY DIFFERENTIAL LITIGATION COSTS

	B VALUES				
	1	2	3	4	5
Target's minimum asking price (P_{LOW})	9	9	9	9	9
Bidder's maximum bid price (P_{HI})	11	12	13	14	15
Midpoint of range ($[P_{\text{LOW}} + P_{\text{HI}}] \div 2$)	10	10.5	11	11.5	12

NOTE.—This example shows that even if delay produces no other superior takeover bids, the maximum bid price of the bidder increases directly with the factor B, which is the given ratio of bidder to target litigation costs. This example assumes perfect knowledge, and the bid and ask prices are expressed on a pro rata basis per target share, assuming 100 percent tendering. Definitions:

$P_T = 20$
$P_E = P_0 = 10$
$F = 50$ percent
$P_I = 15 = .5\,(20) + .5\,(10)$
$G = 20$
$NG_T = P_I - P_0 = 5$
$NG_B = G - P_I = 5$
$L_B = BL_T$
$L_T = 1$
$P_L = 10$ (delay produces no auction)

A. DEFINITIONS

P_0 = value of target common stock (per share) under incumbent management;
N_0 = number of outstanding shares of voting common stock of the target and of the bidder;
P_T = tender price per share purchased;
P_E = ex post price of target shares held by minority if offer succeeds;
N_S = number of shares sought;
N_T = number of shares tendered;
F = fraction of shares from each tendering account accepted: pro rata offer;
P_I = interim price; market price after announcement, before execution, assuming $N_T = N_0$;
NG_T = profit of target (per target share) if offer succeeds;
NG_B = profit of bidder (per target share) if offer succeeds;
G = maximum price bidder is willing to pay for the target (per target share) absent litigation;
L_T = target's litigation costs;
L_B = bidder's litigation costs ($L_B = BL_T$, assuming $B \geqslant 1.0$);
P_L = alternative value of target after delay;
P_A = takeover price of target after delay ($P_A = P_L - P_T$);
NB_{TS} = profit of target (per target share) after litigation;
NG_{BS} = profit of bidder (per target share) after litigation;
P_{LOW} = takeover price (pro rata, per target share) that sets $NG_T = NG_{TS}$, which is minimum ask price of the target;
P_{HI} = takeover price (pro rata, per target share) that sets $NG_B = NG_{BS}$, which is maximum bid price of the target.

B. EQUATIONS

1. If the offer induces 100 percent tendering and is prorated and there is no litigation, then the following equations hold:

$$
\begin{aligned}
P_I &= F \times P_T + (1 - F) \times P_E \\
F &= \frac{N_s}{N_0} \\
NG_T &= P_I - P_0 \\
NG_B &= G - P_I.
\end{aligned}
$$

2. If the offer is resisted through target litigation, then the following equations hold, assuming perfect knowledge:

$$
\begin{aligned}
NG_{TS} &= P_A - P_0 = (P_L - L_T) - P_0 \\
NG_{BS} &= (G - L_T) - P_A - L_B \\
P_{\text{LOW}} &= P_A \\
P_{\text{HI}} &= P_A + (L_T + L_B).
\end{aligned}
$$

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New York
University
Law Review

Volume 59
Number 2
May 1984

DO TARGETS GAIN FROM DEFEATING TENDER OFFERS?

Frank H. Easterbrook
and
Gregg A. Jarrell

REPRINT

DO TARGETS GAIN FROM DEFEATING TENDER OFFERS?

FRANK H. EASTERBROOK AND GREGG A. JARRELL*

Do shareholders benefit from management decisions to resist tender offers? Professor Easterbrook and Mr. Jarrell think the evidence is unequivocal. They cite three recent studies of post-offer movements in the prices of target stocks which show that successful defensive tactics by management have deprived target shareholders of appreciation gains worth between fifteen and fifty-two percent of the value of target shares. They then introduce the results of their own more conventional study: had these gains been realized and reinvested in equity securities, shareholders would have fared considerably better during the past decade. The authors argue that a similar study by Kidder, Peabody & Co. reaches a seemingly contrary result because it erroneously compares the post-offer performances of these target stocks to the rate of inflation rather than to the performance of the equity market. The latter far outpaced inflation in recent years and thus, in the authors' view, provides a better measure of the true cost of defensive tactics to investors. This cost is enormous, the authors conclude, and warrants close judicial scrutiny, if not outright prohibition, of defensive tactics.

INTRODUCTION

One of the central questions in the debate about managers' responses to tender offers is whether defensive tactics are likely to make the targets' shareholders better off. If the defeat of an offer benefits these shareholders, then it follows that the decisions whether and how to defend should receive the same protection the business judgment rule accords other managerial decisions. If, on the other hand, the defeat of an offer is bad news for the target's shareholders, application of the business judgment rule is less defensible.

The business judgment rule is designed to protect managers from judicial reassessment of decisions that may or may not turn out well for the firm.[1] It reflects the fact that business decisions are risky and often in retrospect seem ill-advised. The business judgment rule gives managers the freedom to err, and thus it facilitates risk-taking. Perhaps more fundamentally, it reflects the fact that error-prone managers eventually are "selected out" by the process of competition among firms and among managers themselves.[2] Judges, on the other hand, are not chosen for their business acumen and are not fired or subject to reductions in salary if they err in assessing business situations. Judges also are accustomed to deciding cases on full records and may be too quick to blame managers who act—as they often should—in haste or on incomplete information. It is better to insulate all honest decisions from review than to expose managers and directors to review by judges and juries who do not face market pressures.

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[1] See, e.g., Joy v. North, 692 F.2d 880, 885-87 (2d Cir. 1982), cert. denied, 103 S. Ct. 1498 (1983); Aronson v. Lewis, 473 A.2d 805, 812-15 (Del. 1984). See generally Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 Nw. U.L. Rev. 913 (1982); Veasey, Seeking a Safe Harbor from Judicial Scrutiny of Directors' Business Decisions—An Analytical Framework for Litigation Strategy and Counselling Directors, 37 Bus. Law. 1247 (1982).

There has always been increased judicial scrutiny, though, of decisions by managers with conflicting interests.[3] Under the law of most states, these decisions are scrutinized for "fairness." This means that judges ask whether a decision of this type could have been reached by people acting at arms' length, with no self-interest. Judges are better at policing managers' loyalty than at policing their astuteness.

Tender offers create conflicts of loyalty in almost every case: to defend against the offer is to defend against a threat to one's job as well. Managers' promises of fidelity to shareholders' interests are less likely to be honored when the stakes are so large for the managers themselves. Even when the evidence of conflicting interests is weak, some courts have been willing to restrict the scope of managers' discretion. For example, some courts have closely scrutinized directors' efforts to dismiss derivative litigation pending against fellow directors.[4] When the evidence of conflict is convincing—when certain kinds of self-interested decisions always or almost always turn out poorly for the shareholders—the rationale of the business judgment rule is seriously undermined.

Defensive responses to tender offers could be classified as "ordinary" business decisions and protected by the business judgment rule. They could be classified as "self-interested" decisions and subjected to review for "fairness." Or they could be classified as outside the scope of managers' implicit authority and banned altogether. Each of these positions has its partisans.

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[2] See Easterbrook, Managers' Discretion and Investors' Welfare: Theories and Evidence (collecting and discussing the evidence about how markets influence and discipline managers) (on file at New York University Law Review).

[3] Where a director has a personal interest in fending off a threat to corporate policy and control, courts do not presume that the director has acted in the corporation's interest. See, e.g., Cheff v. Mathes, 199 A.2d 548 (Del. 1964); Bennett v. Propp, 187 A.2d 405 (Del. 1962); Condec Corp. v. Lunkenheimer Co., 43 Del. Ch. 353, 230 A.2d 769 (1967).

[4] Compare Joy v. North, 692 F.2d 880 (2d Cir. 1982), cert. denied, 103 S. Ct. 1498 (1983) and Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) with Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). See generally Scott, Corporation Law and the American Law Institute Corporate Governance Project, 35 Stan. L. Rev. 927, 940-46 (1983).

Recent judicial decisions, supported by much commentary, apply the ordinary business judgment rule.[5] The cases are not very strong, though. Each of the three most important was decided by a vote of 2-1, and state courts have yet to speak. In contrast, some scholars have argued for outright prohibition of defensive tactics.[6] (There is a further dispute about whether attempts to find "white knights" and run auctions, in addition to attempts to remain "independent," should be within such a ban.[7] For current purposes we examine only outright defenses, by which firms seek to defeat all offers.) The SEC's Advisory Committee on Tender Offers took a middle position, proposing to permit some defensive tactics, to regulate others by requiring special votes of shareholders, and to ban some under defined circumstances.[8] Some courts, too, have used the Williams Act to prohibit certain defensive tactics.[9] Such decisions appear to have support from the Supreme Court's statement, in the course of invalidating state anti-takeover laws, that defensive tactics are damaging to shareholders.[10]

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[5] See Panter v. Marshall Field & Co., 646 F.2d 271, 293-99 (7th Cir.), cert. denied, 454 U.S. 1092 (1981); Treadway Cos. v. Care Corp., 638 F.2d 357, 380-84 (2d Cir. 1980); Johnson v. Trueblood, 629 F.2d 287, 292-93 (3d Cir. 1980), cert. denied, 450 U.S. 999 (1981); see also Herzel, Schmidt & Davis, Why Corporate Directors Have a Right to Resist Tender Offers, 3 Corp. L. Rev. 107 (1980); Lipton, Takeover Bids in the Target's Boardroom: An Update After One Year, 36 Bus. Law. 1017 (1981) [hereinafter Lipton Update]; Lipton, Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel, 55 N.Y.U. L. Rev. 1231 (1980); Lipton, Takeover Bids in the Target's Boardroom, 35 Bus. Law. 101 (1979); Lowenstein, Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation, 83 Colum. L. Rev. 249 (1983); Note, Tender Offer Defensive Tactics and the Business Judgment Rule, 58 N.Y.U. L. Rev. 621 (1983).

[6] See Baron, Tender Offers and Management Resistance, 38 J. Fin. Econ. 331, 342 (1983); Bebchuk, The Case for Facilitating Competing Tender Offers, 95 Harv. L. Rev. 1028, 1029, 1054 (1982); Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161, 1198 (1981); Easterbrook & Fischel, Takeover Bids, Defensive Tactics, and Shareholders' Welfare, 36 Bus. Law. 1733, 1733 (1981); Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 Stan. L. Rev. 819, 878-79 (1981); see also SEC Advisory Committee on Tender Offers, Report of Recommendations 99-104, 109-20 (1983) (separate statement of Easterbrook and Jarrell arguing for a prohibition of defensive tactics as a second-best solution to the inequalities created by the Williams Act and responding to arguments favoring unrestrained defense) [hereinafter Advisory Committee Report].

One important assumption in these anti-defense arguments is that the Williams Act or some equivalent set of rules hinders the tactics of bidders and gives the targets' managers the opportunity to mount effective defenses. If bidders were free to select their tactics, we and many of the other authors listed above would take a quite different position on judicial review of defensive tactics.

[7] Compare Easterbrook & Fischel, Auctions and Sunk Costs in Tender Offers, 35 Stan. L. Rev. 1 (1982) (opposing auctions as well as outright defense) with Bebchuk, The Case for Facilitating Competing Tender Offers: A Reply and Extension, 35 Stan. L. Rev. 23 (1982) (opposing defense but not auctions) and Gilson, Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense, 35 Stan. L. Rev. 51 (1982) (same, but on different arguments).

Many paths lie ahead. The recommendations of the SEC's Advisory Committee must be considered by Congress and the SEC, as well as by the state legislatures and the courts.[11] The American Law Institute's Corporate Governance Project will address tender offers and defensive tactics. Although some portions of the ALI's project have been circulated in draft form, the part on these subjects has not been written. Proposed revisions of the ABA's Model Business Corporations Act are circulating for comment, and the proposals contain recommendations that bear on these subjects. Congress, the SEC, the ALI, and the ABA all need to know whether defensive tactics are likely to make the targets' shareholders better off. To shed light on this issue, we present some evidence from financial economics and then consider the major piece of contradictory evidence. We show that, when viewed in the proper light, the evidence is not contradictory at all. Both sources of evidence demonstrate that targets' shareholders lose when managers defeat tender offers. Because what is good for investors in this respect is good for the economy as a whole, the loss is felt widely.[12]

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[8] Advisory Committee Report, supra note 6, at 13 (considering regulations of auctions), 18 (Rec. 9.b recommends that the business judgment rule govern takeover contests), 34 (Rec. 33 endorses business judgment rule, subject to caveat in n.31 and Rec. 34 concerning state anti-takeover laws), 36 (Rec. 35 opposes high barriers to change of control in articles and bylaws), 36-37 (Rec. 36 calls for supermajority voting on some anti-takeover provisions), 38-39 (Rec. 37 calls for advisory votes on some defensive provisions), 40-41 (Rec. 38.a would ban Golden Parachutes adopted after commencement of an offer), 42 (Rec. 39.b would prohibit self-tender with expiration date in advance of bidder's date), 43 (Rec. 40 would ban PAC-MAN defense as a response to a bid for 100% of target's stock), 44 (Rec. 41 would limit issuance of stock during offer to 15%, unless shareholders' approval obtained).

[9] See Mobil Corp. v. Marathon Oil Co., 669 F.2d 366 (6th Cir. 1981) (lock-up options granted by target to competing tender offeror manipulative); Data Probe Acquisition Corp. v. Datatab, Inc., 568 F. Supp. 1538 (S.D.N.Y.) (same), rev'd, 722 F.2d 1 (2d Cir. 1983). Contra Buffalo Forge Co. v. Ogden Corp., 717 F.2d 757, 760 (2d Cir.) (sale of option and treasury stock by target to competing tender offeror not manipulative), cert. denied, 104 S. Ct. 550 (1983); see generally Note, Target Defensive Tactics as Manipulative Under Section 14(e), 84 Colum. L. Rev. 228 (1984).

[10] Edgar v. MITE Corp., 457 U.S. 624, 643 (1982) (defenses hinder the "reallocation of economic resources to their highest valued use" and reduce "the incentive the tender offer mechanism provides incumbent management to perform well").

[11] The SEC has endorsed some of the Advisory Committee's proposals, rejected some, and stated that it needs more time to examine others. See Statement of John S.R. Shad, Chairman of the SEC, to the House Subcommittee on Telecommunications, Consumer Protection and Finance [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,511 (Mar. 28, 1984). The Commission appears quite skeptical about defensive tactics, proposing (among other things) to prohibit the issuance of lock-up options amounting to more than 5% of a firm's stock without approval by shareholders. See Tender Offer Reform Act of 1984, H.R. 5693, 98th Cong., 2d Sess. (1984). It has expressed doubt, though, that anti-defense rules should come from federal rather than state law.

I

THE EVIDENCE ABOUT DEFEATED OFFERS

A. *Direct Price Comparisons*

There are two kinds of evidence about the consequences of defensive tactics. Those who support defensive tactics have argued that corporations that fend off tender offers often do quite well. Martin Lipton describes the fate of McGraw-Hill, which defeated an offer for $40 only to see the price of its stock rise above that level within two years, as an example.[13] According to Lipton, other targets also prosper after defeating offers. This line of argument draws substantial support from a study by Kidder, Peabody & Co.

The Kidder study[14] analyzes 38 defeated hostile tender offers between 1974 and 1982 in which the target remained independent for at least one year. The study used four different methods to assess the effect of defeating a tender offer. Depending on the method used, the study purports to show that the shareholders of between 45% and 97% of all targets did better, as a result of the defeat of the offer, than they would have done if the offer had succeeded. At the low end of Kidder's range is a comparison of the price on February 28, 1983, discounted at the rate of inflation, versus the offer price. The discounted February 28 price exceeded the offer in 45% of all cases. The high end compares the highest price a stock attained after the offer with the original offer; 97% of the "highs" exceed the original offer.

The inference many draw from the Kidder study is that defense often is beneficial to targets' shareholders. If this inference is correct, then it seems to follow that managers' decisions should be fully protected by the business judgment rule.[15] On the other hand, if the Kidder study is misleading, quite a different inference is in order.

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[12] Some people have said that tender offers may be socially bad, though privately profitable, because they "use up credit" or otherwise distort markets. This kind of criticism reflects ignorance of how credit markets work, as the SEC's Advisory Committee unanimously recognized. See Advisory Committee Report, supra note 6, at 13-14, 72-74.

[13] See Lipton Update, supra note 5, at 1026.

[14] The Kidder study was submitted to and considered by the SEC's Advisory Committee on Tender Offers.

B. Evidence from Financial Economics

There is a body of evidence that suggests that the Kidder study is not the right way to look at things. This evidence, developed through the use of the powerful tools of financial economics, focuses on the movements in the price of stock at the time an offer is made and at the time it is defeated. The methodology works roughly as follows.[16] First examine the movements of a firm's stock in the recent past to determine its "beta"—the extent to which its movements are a function of the market's or some industry group's movements. For example, if on average a stock's price rises 2% when the market (or its industry group) rises 1%, and falls 2% when the market falls 1%, the stock has a beta of 2. Then use the stock's beta, together with knowledge of what other stocks did near the time of a tender offer, to determine any "abnormal" movements in the price of the stock. If the stock has a beta of 2, and the market rises 2% on a given day, we expect the stock to rise by 4% on average. If it rises 6%, then it has done better than expected, and the 2% difference is an unexpected gain to investors. If, instead, it rises only 1%, it has done 3% worse than expected; we infer that something bad happened to the firm in relation to the market. The next step in the process is to examine the abnormal gains and losses of all targets near the time tender offers are made and withdrawn. Do they gain, relative to expectations, when offers are made? Do they gain, relative to expectations, when offers are defeated and withdrawn? The final step is to separate targets that defeated offers into two groups. The first contains targets that remained "independent." The second contains targets that were acquired by another bidder, whether this occurred with the target's consent or over its objection.

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[15] Only "seems" to follow because what is beneficial to shareholders when an offer is on the table is not necessarily what shareholders would have selected in advance. If a strategy that drives up the price also decreases the likelihood of an offer, it may or may not help shareholders. See the exchange of views in note 7 supra.

[16] For more detailed statements of the method and its applications, see, e.g., Brown & Warner, Measuring Security Price Performance, 8 J. Fin. Econ. 205 (1980); Fischel, Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities, 38 Bus. Law. 1 (1982); Schwert, Using Financial Data to Measure Effects of Regulations, 24 J.L. & Econ. 121 (1981).

Three studies of this character have been performed in an effort to determine the effects of defensive tactics.[17] All three studies show that investors in firms that defeated offers and remained independent for some time lost significantly when compared with the value of the offer and the value of successful transactions. They disclose identical patterns: the price of a target's stock rises dramatically, approximately 30% relative to the rest of the market, when an offer is announced. If the first offer is defeated and a later offer succeeds, the price rises a little more. If the offer is defeated and no other takes its place, the entire gain is lost. At the cost of omitting some other important data and qualifications, we summarize the findings as follows:

Study	Appreciation on Announcement of Bid	Effect of Defeat*	Effect of Sale in Auction*	Cost of Defeat
Asquith	ca.15%	+1.0%	n.a.**	ca. −15%***
Bradley, Desai & Kim	35.5%	+3.43%	55.73%	−52.3%
Jarrell	30.0%	+9.0%	38.00%	−29.0%

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* Relative to pre-offer price. The Bradley, Desai & Kim data show effects one year after the initial bid; the Jarrell data show effects 100 trading days after the bid; the Asquith data show effects 60 trading days after the bid.

** Asquith's method of reporting data does not permit us to extract this number.

*** To compute the cost of defeat, we simply used the appreciation on the announcement of the bid as an estimate of the opportunity cost of defeating the bid.

The table shows, to use the Bradley study as an example, that when a bid was announced stock prices appreciated by about 35%. When a bid was defeated, the price fell back to approximately the same level as before the bid (an increase of 3.4% relative to pre-bid price); when it succeeded, the average auction premium was about 56%. Thus the loss the shareholders suffered because of defeat, the available premium less the post-defeat value, was about 52% of the total value of the stock. The effect in no-auction cases is the first column (35%) less the second, or a loss of about 32%. All studies demonstrate very large differences between how shareholders fared when their firms defeated offers and how they would have fared had the offers been successful. (The other studies apply slightly different methods of analysis to different samples of offers over different periods of time. Thus the difference in the results is not surprising.)

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[17] See Asquith, Merger Bids, Uncertainty, and Stockholder Returns, 11 J. Fin. Econ. 51 (1983); Bradley, Desai & Kim, The Rationale Behind Interfirm Tender Offers: Information or Synergy?, 11 J. Fin. Econ. 183 (1983); Jarrell, The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge? (forthcoming in J.L. & Econ.) (draft on file at New York University Law Review). For a comprehensive summary of many related studies, see Jensen & Ruback, The Market for Corporate Control: The Scientific Evidence, 11 J. Fin. Econ. 5 (1983).

We find these data exceptionally powerful. All three studies show that the defeat of an offer means very large losses for investors. Other people are reluctant, however, to draw the obvious inference. In presenting these findings to the SEC's Advisory Committee on Tender Offers, and in other forums, we have encountered a number of responses worthy of brief discussion. Before we start, though, it is important to realize that the methods generating these numbers are not controversial within the economics profession. There is no debate about this subject in the way monetarists, Keynesians, and supply-siders debate employment and inflation. The method of analyzing market returns is almost universally accepted as valid, subject only to questions about the sources of data and the exact structure of the equations.[18]

1. *Profits Versus Prices*

The data we report are based on stock market movements at the time of the events, not accounting numbers or "real" profits. Thus, it may be said, they do not show either social gains or "reliable" gains to investors. As it turns out, accounting profit studies also do not measure real social gains,[19] but this is not terribly important here. For investors, what matters is that they can cash out immediately at a gain and invest elsewhere.[20] For society, what matters is that the higher prices accompanying acquisitions reflect estimates of future gains. Prices are reasonably good proxies for these gains, at least when large numbers of firms are involved, because stock prices are based on estimates of future real profits and dividends. Higher equity prices also attract new capital into the market and increase the rate of savings. (For what it is worth, the available evidence on the profitability of tender offers suggests that they result in no unusual profits or losses. In other words, an investment of $X in a target appears to be about as profitable for a bidder as an investment of $X in other assets, such as new plants. This is what one would expect to see if managers of bidders are behaving rationally.)

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[18] There is, for example, debate about whether the "arbitrage pricing model" offers slightly better estimates than the model used in the studies we described; about the strength of the inferences; and about the comprehensiveness of the samples of events on which the conclusions are based. These differences, even taken together, affect only the magnitude rather than the existence or direction of the effects described.

[19] See Fisher & McGowan, On the Misuse of Accounting Rates of Return to Infer Monopoly Profits, 73 Am. Econ. Rev. 82, 97 (1983); Liebowitz, What Do Census Price-Cost Margins Measure?, 25 J.L. & Econ. 231, 245-46 (1982).

[20] For purposes of this analysis, we disregard other considerations that might affect a shareholder's decision to cash out: the tax consequences and transaction costs of selling stock, the costs of locating a suitable alternative investment, and the availability of a market for the stock or a satisfactory appraisal remedy.

A related argument is that the finance studies emphasize the short-term results at the expense of the longer term. Managers, it may be said, know the longer term better than the market. This criticism misses the mark for two reasons. First, it is not accurate to say that the studies of abnormal returns are flawed because they look only at "instantaneous" price changes and not changes over a longer period. The studies do both. The studies summarized in the table above offer an "instantaneous" result in the first column. They tell you what happens to all of the target's stock when a bid is made for part or all. (The reason the abnormal gain is less than the average premium of 50-70% is that most bids are for less than all stock, and some bids fail. The "all stock" appreciation reflects the fact that not all investors will receive gains in all cases.)

The results in columns two to four are *delayed* results. Column three shows offers that we know in retrospect were successful. The investors in targets in these successful offer cases receive appreciation higher than the gains that we observe on the day the offer is made. Column two shows targets that we know in retrospect defeated all offers for an extended period. The investors in *these* targets show either losses, two years later, relative to the pre-bid price (Bradley, Desai & Kim) or losses, four months later, relative to the initial price (Jarrell). The losses relative to successful bids, shown in column four, are staggeringly large.

The second reason why this criticism is unavailing is simple: many careful studies have shown that the price of stock on any given day *is* the best estimate of the price of stock in the future. We return to this below.

2. *Unusual Events*

The studies of tender offers treat gains and losses to investors as averages, while individual cases may diverge from the pattern. This is true, but the implication is obscure. When legislatures or courts design rules of law, they must act on the basis of averages rather than outlying or unusual events. Society gains from inventions and the construction of new plants, even though many inventions and new plants are wastes. The fact that in 5% of all cases the investors of targets that stay independent may gain is not a very good excuse for defense, as a rule, if the other 95% lose and if—as we think likely—any rule of law designed to protect the 5% also affects the other 95% to their detriment.[21]

3. *Imperfect and Incomplete Evidence*

The studies we have mentioned inevitably have flaws. They are based on incomplete samples of tender offers and may be affected by the quirks of particular offers. Thus one cannot say the data are "conclusive." Yet this is an unrealistic demand for economic data. Suppose we were to study business decisions about whether to engage in searching for new ways to grow corn, or about introducing new products, or building new plants. The evidence about the profitability of these highly beneficial things is much less powerful than the evidence about tender offers. To believe, as some apparently do, that society does not lose much if managers defeat offers because the data do not conclusively prove the damage of such actions is to believe that society also would not lose if Congress systematically set about to discourage new ideas, new products, and new plants.

4. *Inefficient Markets*

Many people just cannot believe that stock markets are efficient, and they reject all studies and inferences that in their view are based on assumptions concerning efficiency. Louis Lowenstein is a good example. He argues that many targets are "well managed," so tender offers are unlikely to be value-increasing, and that markets cannot be efficient because stock prices jump around "too much" in relation to "intrinsic values" for the market to be pricing them well.[22] Thus, Lowenstein argues, the stock market data are misleading and independence is a beneficial goal.

There is an enormous body of evidence showing that stock markets are efficient both in the sense that the price of stock on any given day is the best estimate of its future price and in the sense that movements in the price of stock are "unbiased" (meaning that changes neither overshoot nor undershoot the price in the longer run).[23] Those who challenge the efficiency of the stock markets usually do not take issue with these findings. They maintain, rather, that the markets are inefficient in the sense that "the price is not right." That is, they observe (accurately) that often a stock is over- or under-priced in relation to its "true" (future) value.

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[21] Investors prefer whatever arrangement maximizes total gains. This is obvious if each investor holds a diversified portfolio, but it is also true of undiversified investors. See Makowski, Competition and Unanimity Revisited, 73 Am. Econ. Rev. 329 (1983); cf. Easterbrook & Fischel, Corporate Control Transactions, 91 Yale L.J. 698, 711-14 (1982). Because shares are tradeable and are repriced in response to legal rules, no rule can succeed in transferring income from one class of investors to another.

[22] See Lowenstein, supra note 5, at 289-94.

Efficiency in this "right price" sense is not, however, an assumption of the method used in the studies we reported above. Evaluation of the gains and losses from offers depends only on the assumption that the degree of pricing accuracy does not change rapidly. So long as the price a year from now is about as likely as today's price to be "right," inferences based on large numbers of cases will be reliable. "Wrong" prices will offset one another, and any substantial changes in average prices, or average responses, will enable us to determine the costs and benefits of defensive strategies.[24]

C. The Kidder, Peabody Study Once More

A substantial number of skeptics remain. We have heard over and over the question: "If these studies are right, then what about the Kidder, Peabody study?" The implication is that the Kidder study is countervailing data, and that the dispute calls for continued application of the business judgment rule.

The Kidder study examines the consequences of defenses by comparing the bidder's offer against an "adjusted" price of the target's stock at some later time. The adjustment takes into account any inflation during the time between the offer and later price. If the bid was made in 1980, and the later price was observed in 1982, Kidder deflated the 1982 price to "1980 dollars" using the Consumer Price Index (CPI). It then compared this deflated price with the offer. If the deflated price exceeded the offer, Kidder concluded that the defense was beneficial for the target's investors. Using this definition, Kidder concluded that investors gained between 45% and 97% of the time (depending on the subsequent date chosen).

We have checked the Kidder sample, data, and computations. We found no serious errors. Yet we are unshaken in our belief that successful defenses are calamities for the target's investors. This is so because the Kidder study simply is not inconsistent with the work examining abnormal returns. The Kidder study is a textbook example of how, if you approach data with the wrong question, you will get a misleading answer.

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[23] See R. Brealey, An Introduction to Risk and Return from Common Stocks 3-20 (2d ed. 1983) (summarizing many of the pertinent studies); see also J. Cragg & B. Malkiel, Expectations and the Structure of Share Prices (1982) (impressive demonstration that market professionals do not "beat the market," as they should if there were unexploited opportunities for those with the best information to outguess today's price).

[24] See Advisory Committee Report, supra note 6, at 107-09, 116-18 (separate statement of Easterbrook and Jarrell discussing the role of "efficiency" in creating and interpreting similar data).

To understand why Kidder's question is wrong, consider a simple example. Suppose you own stock in Widgets Inc., which on December 1, 1980, was trading for $20. The next day Raider Corp. bids $30 for 100% of the stock. If successful, Raider would pay cash on January 1, 1981. Widgets Inc. beats back the offer, and you are left with shares that on January 1 trade for $20. Two years later, your stock trades for $34 (including the value of reinvested dividends). The 70% gain over $20 looks pretty good. Are you better off? Kidder would say "yes." The $34 is higher than the $30 bid, and if you adjust the $34 to "1981 dollars" you still have more than $30. Kidder would view anything over $33.94 as a gain.[25]

You would disagree with Kidder, though, if you thought you could do better than inflation with your investments. Suppose you had $30 in hand on January 1, 1981, to invest however you wanted. If you had bought a market basket of stocks, you would have had more than $34 by January 1, 1983, because during that time a value-weighted index of New York Stock Exchange firms, including reinvested dividends, rose 14.64%, exceeding inflation.[26] Knowing how Widget Inc. does against how you would have done with the cash is the sort of comparison you would care about. The stock versus the CPI does not tell you much unless by accident the market just tracks inflation. As it turns out, though, for most of the period covered by the Kidder study, especially 1980 and 1982-83, the stock market gain was much greater than inflation. Thus the Kidder study is seriously biased because it ignores what happened to other equity investments.

The extraordinary rise in the stock market over 1980-83 places the defeated bids in a different perspective when compared with the subsequent price of the target. Kidder labels defeats as beneficial just because the whole market rose. Similarly, if the market had fallen, Kidder's method would have greatly overstated the losses incurred by investors in targets, because the price of the targets would have gone down with the market while the imputed value of the bids would have risen with inflation. None of this is a very satisfactory way to assess consequences for investors.

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[25] The Consumer Price Index increased 8.9% in 1981 and 3.9% in 1982. Thus $30 × 1.089 × 1.039 = $33.94.

[26] This figure and all the others in our study come from the tape of daily stock prices maintained by the Center for Research in Securities Prices at the University of Chicago.

It is possible to make an accurate comparison only by taking into account how the market as a whole behaves. We tried to do this. To see how investors really fared, we did a new study, using all of the firms in the Kidder sample that were traded on the New York or American Stock Exchanges, according to the following method. This method uses none of the assumptions and practices that are challenged by those who do not accept the findings of modern financial economics.

We assumed that the targets "accepted" the bidders' offers and that the shareholders invested the proceeds in a diversified portfolio of all equities traded on the New York and American Stock Exchanges. (Of course particular investors would have purchased some less complete sample, but the market as a whole indicates how investors as a whole would have done.) Then we examined this investment one, two, three, etc., months after the offer to see how the portfolio was performing compared with the targets' actual stocks (given the real defeats of the offers). If the portfolio was doing better than the target, we viewed the defeat of the offer as bad news for the targets' shareholders.[27]

We constructed an index that compares the results of the actual investment (given the defeat of the offer) with the hypothetical investment following the hypothetical success of the offer. If the two are equal at any time after the offer's defeat, the index is 1.00. If the actual stock is 10% higher than the basket of equities obtained after success, then the index is 1.10. If, however, the shareholder would have done better with the defeated offer, the index is below 1.00. If, for example, the target's stock does 10% worse than the investor would have expected to achieve in the market, the index is 0.90.

The results of this study are striking. A month after the offers, the targets' stock was trading for about 10% less than the "invested proceeds." Two months later, we see a further 10% decline. Three months (60 trading days) after the offers, 27 of the 31 firms in our sample have index values less than one. Five months (100 trading days) after the offer, 28 of 31 still have indices less than one; the average index is .83.

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[27] This method actually understates, by a substantial amount, the gains the investors would demand to make them indifferent between the success of the offers and their defeats. There has been a generally rising market in equities. The stocks of individual targets are riskier investments than the stocks of the market as a whole. In order to be indifferent between targets' stocks and the market, investors demand compensation for the risk, and these individual stocks actually rise faster than the market (while other firms, such as AT&T and big utilities, rise more slowly). In treating targets' stocks as if they were as safe as the whole market, we give a substantial advantage to the thesis that defense is beneficial. In other words, the method described in the text erroneously assumes that targets' stocks have beta coefficients of one.

Over the course of two years after the offer, the targets as a group fluctuate at a 10% to 20% loss relative to the "invested proceeds." There they sit. The targets never recover. The invested proceeds always do better. So it turns out, if you ask the right question, that the single apparently contrary study is not so contrary after all.

We reproduce our study in an appendix in both tabular[28] and graph form.[29] In the table the company is listed in column one. The other columns give the date relative to the announcement of the offer. Date -20 is 20 trading days (a month) before the offer, and so on. In each column there are two index numbers for each company. The bottom number is the index we have described above. The top number gives the current price of the stock on the listed trading date relative to a basket of equities that could have been purchased by selling the stock 40 days before the offer. This top index will equal 1.00 whenever the offer (followed by defeat) made the shareholders no worse off than they would have been if no offer had ever been made. The final listing in the table, called the "Equal Weighted Portfolio," is the average index of all 31 target stocks. The index number relative to the offer (the lower number in the table) is less than one for the portfolio as a whole on all subsequent dates and less than one for the vast majority of all targets on each subsequent date.

In the first graph the horizontal axis is the number of days after the announcement of the initial bids, and the vertical axis is the relation between the actual price of all target stocks taken as an average (subtracting market movements) and their price at the time of the offer. It is the equivalent of the bottom index in the table. This ratio drops steadily from 1.00 at the time of the offer to about 0.85 after it becomes clear that the offer has been defeated. The second graph is the equivalent of the table's top index. It shows a rise from the average pre-offer price to more than 1.40 at the time of the offer. This is a benchmark; it shows what the investor could have had by taking the offer. The subsequent decline illustrates how the gains slowly ebb away over time as the likelihood that the offer will succeed (or that another offer will be made) goes down.

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[28] See Appendix A at 294-97 infra.

[29] See Appendix B at 298-99 infra.

The table shows that *some* targets' stocks did better than the investor would have done by taking the offer and investing in the market as a whole. For example, 60 trading days (three months) after the offer, four of the 31 firms had indices exceeding one. (We use the second index number from the table because it shows value relative to the offer.) Does this demonstrate that some managers cleverly outguessed the market and saved their investors from losing money?

To test whether the presence of some gains shows astuteness or just random variance, we asked the following question: "If every manager who resisted a tender offer *expected* the firm to lose 10% of its value, what number of firms nonetheless would appreciate just by chance?" In other words, how likely is it that the pattern of gains and losses we observe would exist even if every target expected its index to be 0.90? This is a simple test, for which statistical methods are well developed.[30] The test shows that the probability is about 98.84% that chance alone would have produced four "winners" even if all defeats of tender offers were expected to be bad news for the targets' investors.[31] Indeed, this method of looking at the data predicts that managers *expected* to lose about 20% relative to the market by defeating the offers. Given such an expectation, and given the volatility of the targets' stocks, four targets could have had indices exceeding 1.00, just by chance.[32] That is exactly what happened.

CONCLUSION

It does not matter how one looks at defeated tender offers. Any method that takes into account the movement of the stock market shows that managers who resist tender offers to the point of defeating them do a grave disservice to their investors. The size of the loss is 52% of value by some methods, such as comparing success with defeat in the Bradley, Desai & Kim study reported above; it is 30% of value using the method in Jarrell's study reported in the same table. If we use the most conservative assumptions, such as assuming that targets' stocks are as "safe" as the whole market (which we did in reassessing the Kidder study), we can shrink the size of the loss to 15% or so. But the loss just will not go away. A 15% loss in tender offers of the sort examined here represents an enormous loss in shareholders' equity.

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[30] This statistical approach assumes that prices fluctuate around some "true" value and that the size of the average daily fluctuation is known but the direction of the fluctuation is selected randomly. It is possible to find out how far, and with what probability, a future price would diverge from this "true" value after *n* days of such fluctuations. A large number of trials with a given "true" value and average daily fluctuation will yield a probability distribution, the mean and median of which will be the "true" value, with prices extending higher and lower. By specifying the expected fluctuation and the "true" value, we can therefore find the likelihood that on a given day the actual price in the market will be a given amount higher than the "true" value.

[31] We omit the description of the method, but it is a standard combinatorial problem. It helps to think of the process as one that fills an urn with balls, some of which are colored to reflect the probability that by chance a given firm with a history of fluctuating prices will have an index value exceeding one after 57 days of fluctuations. For the sample of firms here, the chance for each firm is 2,840 in 10,000. If you draw 31 balls from an urn containing 10,000 balls, and 2,840 of the balls are black, what is the chance of getting at least four black balls? We will not go into the math behind the answer, which turns out to be 98.84%.

[32] If you use the method employed in note 31 supra and select an index of 0.80 as the expected or true value, you find that the chance of any one target's index exceeding 1.00 is 12.7%. The best expectation is that you will draw about four black balls in 31 tries from a large urn, if 12.7% of the balls are black.

These findings have substantial implications for the treatment of the business judgment defense. If, as the data show, managers who resist tender offers to the point of defeating them almost always harm the shareholders, there is little reason for judges to accord deference to these decisions and good reason to treat them as self-protective measures. The inference we draw is fortified by still another kind of evidence. Managers who try to defend are overpaid (relative to the firm's profits and the pay of managers elsewhere) and in danger of replacement.[33] Their efforts to keep their salaries and positions are understandable but not excusable. It is past time to prohibit defense or subject it to the most exacting scrutiny to protect the interests of investors.

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[33] Walkling & Long, Agency Theory, Managerial Welfare, and Takeover Bid Resistance, 15 Rand. J. Econ. 54 (1984).

APPENDIX A

Abnormal Performance Indices of Targets that Defeated Tender Offers, for Thirty-One Targets and for Equal-Weighted Portfolio

	TRADING DAYS RELATIVE TO TENDER OFFER ANNOUNCEMENT					
Company	**−30**	**−20**	**−10**	**−5**	**0**	**5**
Amax Inc.	1.0425	1.0402	1.0221	0.9746	1.4614	1.4324
	—	—	—	—	—	1.0644
Brunswick Corp.	0.9517	0.9668	0.9938	1.0067	1.4003	1.5109
	—	—	—	—	—	0.9623
Canal Randolph	1.0382	1.0667	1.1103	1.1277	1.7166	1.4927
Corp.	—	—	—	—	—	1.0808
Chicago Rivet &	0.9571	0.9159	0.9174	0.9674	1.1786	1.2166
Mach. Co.	—	—	—	—	—	1.0249
Dictaphone Corp.	1.1064	1.0946	1.3692	1.4271	1.5679	2.1437
	—	—	—	—	—	1.0577
Foremost-	0.9005	0.9228	0.9715	0.9899	1.0423	1.0583
McKesson Inc.	—	—	—	—	—	0.9806
Gerber Prods. Co.	1.0309	1.0885	1.2042	1.2156	1.2132	1.4304
	—	—	—	—	—	1.0561
Grumman Corp.	0.9349	1.0086	0.9960	0.9745	1.6528	1.5219
	—	—	—	—	—	0.9758
Gulf Res. &	1.0147	1.2369	1.2814	1.2770	1.5840	1.4969
Chem. Corp.	—	—	—	—	—	1.0088
Heinicke Instrs.	1.0325	1.0018	0.9803	0.9785	1.0478	0.9995
	—	—	—	—	—	0.9902
Harnischfeger	0.9746	0.8989	0.9508	0.9658	1.6127	1.6045
Corp.	—	—	—	—	—	0.9623
Harsco Corp.	1.0750	0.9928	1.0452	1.0393	1.2069	1.2413
	—	—	—	—	—	1.0052
Inspiration	0.9519	0.8234	0.7852	0.8224	1.0834	1.0056
Cons. Copper Co.	—	—	—	—	—	0.9659
Kennecott Corp.	0.9551	0.9627	0.8225	1.0276	1.0340	1.0170
	—	—	—	—	—	0.9396
Levitz	0.9828	0.9366	0.9522	0.9477	1.1064	1.1006
Furniture Corp.	—	—	—	—	—	0.9904
Ludlow Corp.	1.1128	1.0794	1.1719	1.3223	1.6757	1.5560
	—	—	—	—	—	0.9540

10	20	40	60	100	160	240
1.3817	1.5693	1.2026	1.3559	1.4480	1.2218	0.9242
1.0267	1.1661	0.8936	1.0075	1.0760	0.9079	0.6868
1.4441	1.4476	0.9899	1.0034	1.2483	1.3128	1.1683
0.9197	0.9220	0.6305	0.6391	0.7950	0.8361	0.7441
1.4532	1.3294	1.3346	1.4094	1.1701	1.0781	1.1606
1.0522	0.9625	0.9663	1.0205	0.8472	0.7806	0.8403
1.2758	1.2466	0.8616	0.8492	0.8008	0.7931	0.6937
1.0748	1.0502	0.7258	0.7154	0.6747	0.6682	0.5844
1.3907	1.4551	1.3952	1.5153	1.4266	0.9661	0.9664
0.6861	0.7179	0.6884	0.7476	0.7038	0.4766	0.4768
0.9833	1.0095	0.9391	0.9384	0.8514	0.8843	0.9715
0.9110	0.9354	0.8701	0.8695	0.7888	0.8194	0.9002
1.3915	1.3537	1.2242	1.2551	1.3051	1.1476	1.2368
1.0274	0.9995	0.9038	0.9266	0.9636	0.8473	0.9132
1.5503	1.3304	1.0820	1.0616	1.1399	1.2127	1.6522
0.9940	0.8338	0.6937	0.6807	0.7309	0.7776	1.0593
1.4913	1.1773	1.0101	0.8566	0.9970	1.0004	1.7253
1.0050	1.7934	0.6807	0.5773	0.6719	0.6742	0.4888
1.0160	1.0391	1.1309	1.0475	0.8196	0.6089	0.5942
1.0065	1.0294	1.1203	1.0377	0.8120	0.0319	0.5886
1.6573	1.5211	1.6140	1.6390	1.4196	0.9140	0.9574
0.9940	0.9123	0.9680	0.9830	0.8514	0.5482	0.5742
1.2206	1.2290	1.1703	1.2018	1.2906	1.3006	1.2795
0.9884	0.9952	0.9477	0.9731	1.0451	1.0532	1.0361
0.9642	0.9776	0.9689	0.8229	0.6932	0.5785	0.5542
0.9261	0.9389	0.9306	0.7903	0.6658	0.5557	0.5323
1.0461	1.0673	0.8870	0.8524	0.7856	0.9426	0.8470
0.9667	0.9863	0.8197	0.7877	0.7260	0.8711	0.7827
1.1755	1.1082	1.0442	1.0484	1.8056	1.9052	0.9004
1.0578	0.9972	0.9396	0.9434	0.7249	0.8145	0.8103
1.6013	1.4568	1.4268	1.1556	1.2393	1.1587	1.0575
0.9818	0.8932	0.8748	0.7085	0.7598	0.7104	0.6483

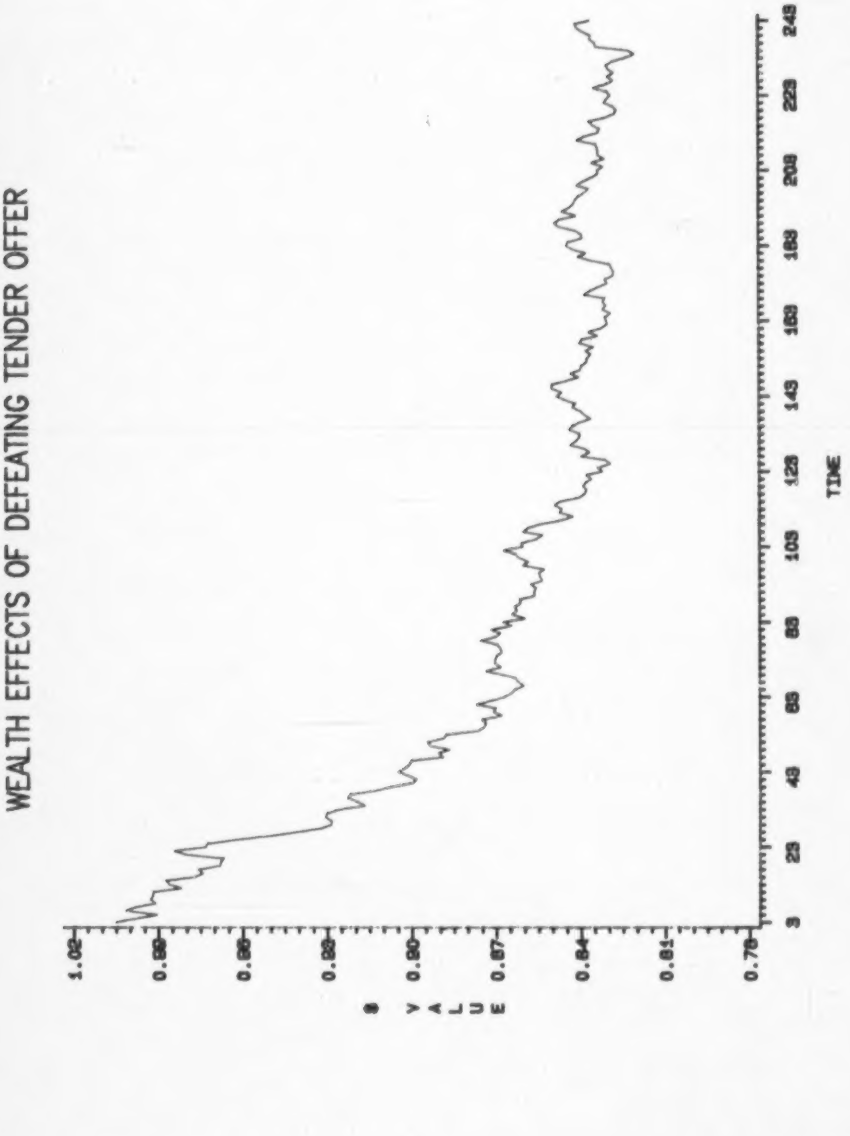
Abnormal Performance Indices of Targets that Defeated Tender Offers, for Thirty-One Targets and for Equal-Weighted Portfolio (Continued)

	Trading Days Relative to Tender Offer Announcement					
Company	**−30**	**−20**	**−10**	**−5**	**0**	**5**
Mead Corp.	0.9012	0.9305	0.9812	0.9550	1.3598	1.2755
	—	—	—	—	—	0.9824
Marshall Field & Co. Del.	1.0325	1.0041	1.1377	1.1223	1.5948	1.4774
	—	—	—	—	—	1.0084
McGraw Hill Inc.	1.0871	1.1398	1.1085	1.1146	1.4070	1.4518
	—	—	—	—	—	0.9628
Pargas Inc.	1.0094	0.9790	0.9586	1.1229	1.3580	1.3060
	—	—	—	—	—	0.9868
Rowan Cos. Inc.	1.0121	1.1258	1.2289	1.1678	1.7422	1.6786
	—	—	—	—	—	0.9872
Sabine Corp.	1.0322	0.9989	1.0083	1.0958	1.2019	1.2310
	—	—	—	—	—	1.0083
Sterndent Mng. Co.	0.9254	0.8457	0.9136	0.8591	0.8364	1.2652
	—	—	—	—	—	0.9906
Sunshine Mfg. Co.	0.9547	1.0086	1.1421	1.1501	1.3560	1.3202
	—	—	—	—	—	0.0691
Simplicity Pattern Inc.	1.0512	1.0411	1.0635	1.0534	1.1231	1.0081
	—	—	—	—	—	0.9270
Texas Int'l Co.	1.1186	1.4456	1.5582	1.6929	1.7308	1.7268
	—	—	—	—	—	1.0194
TeleCom Corp.	1.2820	1.2167	1.1121	1.0985	1.4156	1.3826
	—	—	—	—	—	0.9718
Unitek Corp.	0.9046	0.9412	0.9676	0.8863	1.2081	1.2120
	—	—	—	—	—	0.9926
Universal Leaf Tob. Inc.	0.9817	0.9852	0.9612	1.0093	1.0252	1.1917
	—	—	—	—	—	1.0466
Viacom Int'l Co.	1.0364	1.1587	1.0402	1.0323	1.4132	1.3001
	—	—	—	—	—	0.8800
Woolworth, F.W. Co.	0.9885	1.0840	1.1006	1.1184	1.4682	1.3686
	—	—	—	—	—	0.9605
Equal Weighted Portfolio	1.0125	1.0281	1.0593	1.0820	1.4052	1.4254
	—	—	—	—	—	0.9906

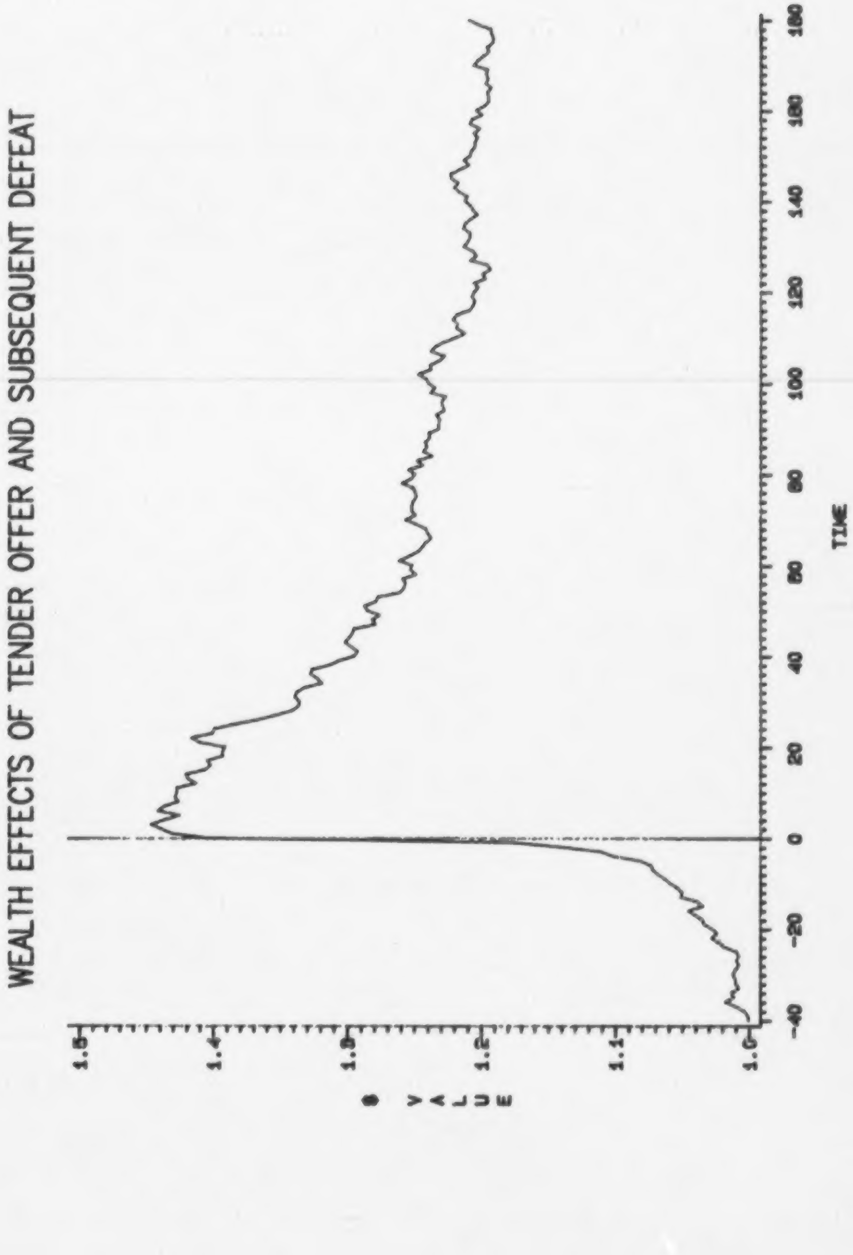
10	20	40	60	100	160	240
1.3145	1.2597	1.2887	1.2650	1.0685	1.1964	1.0657
1.0125	0.9702	0.9926	0.9743	0.8229	0.9215	0.8209
1.5844	1.5254	1.6721	1.0993	1.1574	1.0184	0.8326
1.0815	1.0412	1.1413	0.7503	0.7900	0.6951	0.5683
1.4746	1.3197	1.0842	1.1130	1.0702	1.1025	1.1646
0.9779	0.8752	0.7190	0.7381	0.7098	0.7312	0.7724
1.4112	1.2054	1.1508	1.1528	1.1083	1.1968	1.4246
1.0663	0.9108	0.8695	0.8711	0.8375	0.9043	1.0764
1.6742	1.6117	1.4230	1.3770	1.2652	1.1869	1.4311
0.9846	0.9479	0.8369	0.8098	0.7441	0.6981	0.8417
1.2143	1.2832	1.2094	1.0871	1.2041	1.1950	1.2557
0.9946	1.0510	0.9905	0.8904	0.9863	0.9788	1.0285
1.5074	1.4579	1.2042	1.0443	1.1166	0.9247	1.1009
1.1802	1.1415	0.9428	0.8176	0.8742	0.7240	0.8619
1.2871	1.2537	1.2433	1.2091	1.0935	1.0030	1.0419
0.9448	0.9203	0.9126	0.8875	0.8026	0.7362	0.7648
0.9924	1.0061	1.0700	1.0610	0.9065	0.9416	0.6617
0.9126	0.9252	0.9839	0.9757	0.8336	0.8659	0.6084
1.6338	1.5452	1.5953	1.5069	1.3299	1.5771	1.9577
0.9646	0.9123	0.9418	0.8896	0.7851	0.9311	1.1558
1.3948	1.3102	1.0788	1.0188	1.2654	0.8932	0.6686
0.9804	0.9209	0.7583	0.7161	0.8894	0.6278	0.4700
1.2462	1.1625	1.0584	1.0725	1.0800	1.1575	1.2177
1.0206	0.9521	0.8668	0.8783	0.8845	0.9479	0.9973
1.1761	1.1873	1.1149	1.1772	1.3530	1.2479	1.3325
1.0329	1.0427	1.9798	1.0388	1.1882	1.0959	1.1702
1.3248	1.5259	1.5695	1.3401	1.4481	1.9004	2.1770
0.8967	1.0329	1.0623	0.9071	0.9802	1.2864	1.4736
1.3927	1.3270	1.2453	1.2104	1.2369	1.2094	1.0445
0.9775	0.9314	0.8740	0.8495	0.8681	0.8488	0.7331
1.4275	1.3913	1.2951	1.2521	1.2400	1.2044	1.2074
0.9920	0.9668	0.9000	0.8701	0.8617	0.8370	0.8391

Note: Index 1 is the top index, which measures abnormal performance of target's stock relative to stock price 40 trading days before the announcement of the tender offer. Index 2 is the bottom index, which measures abnormal performance of target's stock relative to stock price three days after the announcement of the tender offer.

APPENDIX B



WEALTH EFFECTS OF DEFEATING TENDER OFFER


WEALTH EFFECTS OF TENDER OFFER AND SUBSEQUENT DEFEAT
$ VALUE
1.0
1.1
1.2
1.3
1.4
1.5
TIME
-40
-20
0
20
40
60
80
100
120
140
160
180

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LAW REVIEW

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Published in April, May, June, October, November, and December by the
Board of Editors of the New York University Law Review

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHIEF
ECONOMIST

MEMORANDUM

April 1, 1985

TO : Joe Grundfest

FROM : Gregg A. Jarrell GA Jarrell
Robert Comment
Tony Tri

The following table summarizes the results from the Office of the Chief Economist's (OCE) correction of the analysis done in Forbes, March 11, 1985, page 139. (See Table entitled "Maximizing Shareholder Value" in attached copy of article.) This article purported to show that in 17 of 39 cases, shareholders of target companies (between 1974 and 1982) that defeated tender offers actually were wealthier as of December 31, 1984 than they would have been had the offers succeeded. The Forbes study is flawed in several respects that, when corrected, reverses completely their conclusions.

The proper test is to invest the proceeds of the tender offer, as if it had been accepted, into a general market portfolio. At some future date, one compares the value of this hypothetical portfolio to the actual stock price to judge whether target shareholders were better off with the market portfolio (offer accepted) or with target stock (offer defeated).

The Forbes article erred when they computed the relative performances of the target stock and the market portfolio in percentages. This computation must use for its base value the target's stock value just after the announcement of the tender offer, before the market discounts the information that the offer is likely to be rejected. Instead, Forbes chose for its base value the target's stock price as of the beginning of the first calendar month at least thirty days after the announcement. For most cases, therefore, Forbes' base value will be considerably below the proper base value, because during this 30 to 60 day interval, the market devalues the target as it learns that the premium offer will not succeed. This error increases falsely the percentage performance of the target stock relative to that of the market portfolio, and causes one to incorrectly conclude for many cases that the target stock outperforms the market portfolio.

OCE's analysis corrects this by choosing as a base value the market price of the target stock three trading days after the first Wall Street Journal announcement of the tender offer (that is ultimately rejected). OCE's analysis contains other differences because of the nature of our computer data base. We exclude six out of 39 cases because the firms are OTC; our data base (The University of Chicago CRSP tapes) excludes OTC firms. 1/ Also, our target stock returns include cash dividends, which the Forbes article omitted, as well as stock splits. We use the CRSP equally-weighted market portfolio containing all NYSE and ASE listed firms, which reinvests cash dividends. Forbes uses the S&P 500, which omits cash dividends. Finally, we run the returns comparisons to 12/31/83, which is when our computer data ends. Forbes continues to 12/31/84.

The table summarizes the results. Of these 33 cases, only four cases show that target shareholders gained by defeating the tender offer. The other 29 cases, or 88% of the total, lose as a result of the defeated tender offer. 2/

1/ We should note that four of these six omitted OTC cases lose by defeating the tender offer, at least according to Forbes' computations. The other two OTC firms benefitted by subsequent takeovers at large premiums.

2/ OCE's results based on the Forbes sample are in close agreement with the empirical results contained in Easterbrook and Jarrell, "Do Target's Gain by Defeating Tender Offers?", The New York University Law Review, Vol. 59, No. 2, (May 1984), pp. 277-99, and Bradley, Desai, and Kim, "The Rationale Behind Interfirm Tender Offers: Information or Synergy?" The Journal of Financial Economics, Vol. 11, No 1-4 (April, 1983), pp. 183-206.

Attachments

Do Target Shareholders Gain by Defeating Hostile Tender Offers? The Forbes Article Rebuked

COMPANY	First Announcement Date	Value on 12/31/83 of One Dollar Invested Immediately After the Announcement In	
		Target Stock	Market
Dictaphone*	9/25/74	$3.04	$4.87
Inspiration Con. Copper*	2/20/74	.91	3.22
Sterndent*	2/14/75	2.07	6.44
Unitek*	5/10/75	1.64	1.47
Pargas*	5/10/76	3.72	6.88
McKesson	5/18/76	3.54	6.90
Sabine	9/22/76	4.66	6.58
Universal Leaf Tob.	10/11/76	3.76	6.95
Viacom International	1/12/77	5.05	5.84
Sunshine Mining	3/23/77	2.06	5.79
Gerber Products	4/19/77	2.53	5.73
Marshall Field*	12/31/77	1.37	2.55
Rowan Cos	6/13/78	1.84	3.95
Mead Corp	8/14/78	1.70	3.60
Wurlitzer	9/25/78	.47	3.53
Levitz Furniture	11/06/78	5.82	4.17
Chicago Rivet & Mach.	1/22/79	.96	3.69
Mission Ins. Gp.	1/08/79	1.90	3.80
McGraw Hill	1/10/79	3.04	3.74
Ludlow*	2/12/79	1.70	1.87
Woolworth F.W.	4/10/79	1.66	3.43
Harnischfeger	6/11/79	.40	3.26
Telcom	8/14/79	.20	2.96
Gulf Res. & Chem.	2/20/80	.61	2.64
Harsco	1/27/81	1.42	2.02
AMAX	3/06/81	.47	1.96
Canal Randolph	5/06/81	2.78	1.83
Heinicke Inst.	7/29/81	1.16	1.79
Grumman	9/24/81	1.56	2.07
Simplicity Pattern	10/29/81	1.13	1.87
Brunswick	1/26/82	2.25	1.91
SCA Services	3/08/82	1.49	2.08
Martin Marietta	8/26/82	1.39	1.84

Note: For Stocks that are delisted from the NYSE/ASE prior to 12/31/83, the dollar value is given as of the de-listing date for both the target stock and the market. De-listed stocks are indicated by asterisks. The dollar values are for one dollar invested three days after the announcement and reflect compounding and re-investment of dividends. The market portfolio used here is an equally weighted portfolio of all NYSE/ASE stocks, as calculated by the Center for Research on Security Prices (CRSP), the University of Chicago.

As the American economic environment changed, predators emerged from under rocks and began to prey on healthy businesses. Is there no stopping them? Will they devour us all?

Why is no one safe?

By Allan Sloan

WHAT KIND OF WORLD are we living in? Texaco, the seventh-largest company in the U.S., is so unnerved by the Bass brothers' buying a 9.9% stake that it hands them a $400 million greenmail profit to go away. Mobil Corp., the fourth-largest company, is so worried that it will be the next company held for ransom that it's asking shareholders to put antigreenmail provisions in its corporate charter.

Not long ago, no one could even conceive of buying Texaco or Mobil, let alone seriously entertain such a thought. Who could raise the money for such a deal? These days, lots of people can. Carl Icahn can send Drexel Burnham Lambert out to raise $4 billion as part of an $8 billion proposal to take over Phillips Petroleum, the nation's 22nd-largest company. T. Boone Pickens and his pipsqueak Mesa Petroleum Co. could so discombobulate Gulf Corp., the nation's 14th-largest company, that it put itself up for sale and was bought for $13 billion by Chevron Corp. The leveraged buyout firm of Kohlberg Kravis Roberts & Co., which came close to buying Gulf, assembled $6 billion of bank loan commitments for a deal that would have had a debt-equity ratio of 30-to-1. Wherever you look, the sharp-toothed little minnows are chasing the whales and sometimes swallowing them.

Who is safe? Only those companies in such wretched shape that no one wants them and those with such a high stock price that no one can afford to pay a premium over the market. Who is vulnerable? All those companies

Billion-dollar babies

It wasn't long ago that buying something for a billion dollars made you distinctive. Xerox, using its overpriced stock, first pierced the barrier with its disastrous purchase of Scientific Data Systems. Ten-digit deals weren't common until the 1980's, with Reaganomics and the 1981 tax law in full swing and antitrust enforcement in full retreat.

1969	1970	1971	1972	1973	1974	1975	1976
Xerox Scientific Data Systems **1.0 billion**						**General Electric** Utah Intl **1.9 billion**	**Mobil** Marcor* **1.8 billion** **Newmont Mining et al.** Peabody Coal from Kennecott **1.2 billion**

*Mobil acquired 54% in 1974 and remaining interest in 1976 whose underlying assets are worth more than the price of their stock—which means most big companies these days.

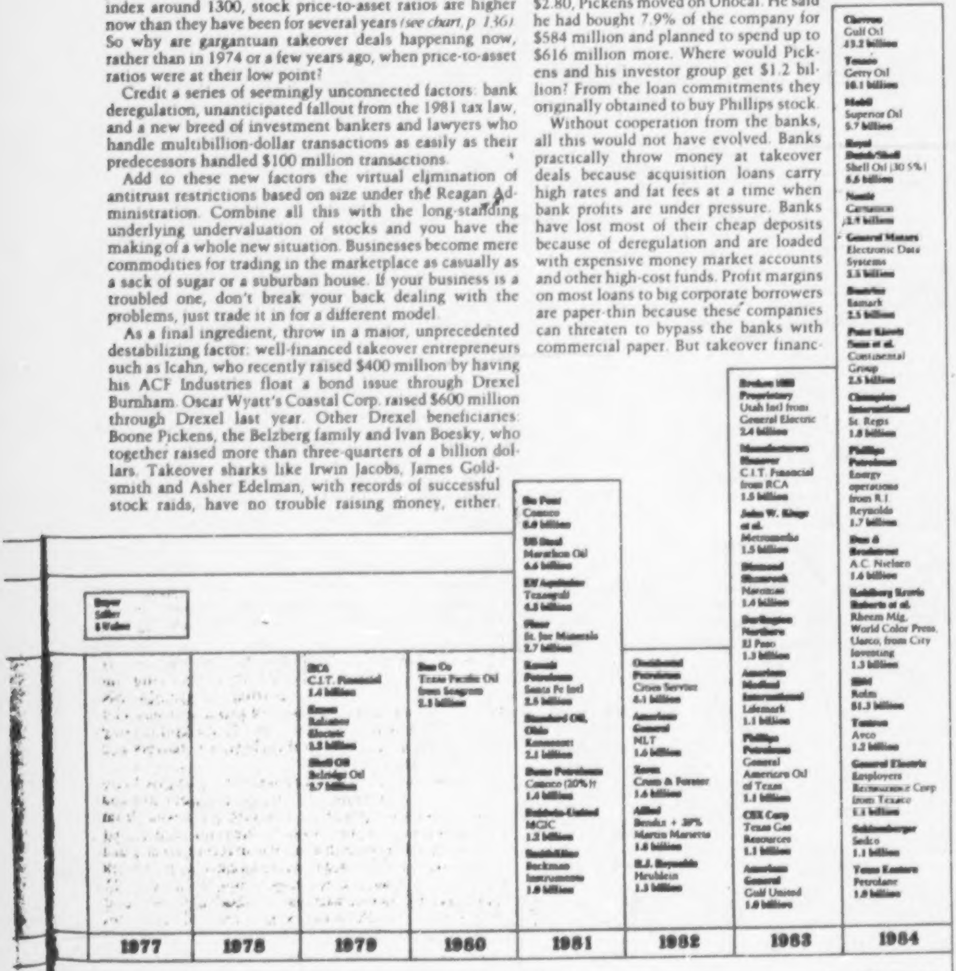
But why are so many big corporations being raided now? Companies' assets have been worth more than their stocks for years—at least since the great stock market crash of 1974, after which stock prices as a whole failed to keep up with the great inflation in property values. Why now, when the stock market has finally come to life and sailed past the old highs set in the 1970s? With the Dow Jones index around 1300, stock price-to-asset ratios are higher now than they have been for several years *(see chart, p. 136)*. So why are gargantuan takeover deals happening now, rather than in 1974 or a few years ago, when price-to-asset ratios were at their low point?

Credit a series of seemingly unconnected factors: bank deregulation, unanticipated fallout from the 1981 tax law, and a new breed of investment bankers and lawyers who handle multibillion-dollar transactions as easily as their predecessors handled $100 million transactions.

Add to these new factors the virtual elimination of antitrust restrictions based on size under the Reagan Administration. Combine all this with the long-standing underlying undervaluation of stocks and you have the making of a whole new situation. Businesses become mere commodities for trading in the marketplace as casually as a sack of sugar or a suburban house. If your business is a troubled one, don't break your back dealing with the problems, just trade it in for a different model.

As a final ingredient, throw in a major, unprecedented destabilizing factor: well-financed takeover entrepreneurs such as Icahn, who recently raised $400 million by having his ACF Industries float a bond issue through Drexel Burnham. Oscar Wyatt's Coastal Corp. raised $600 million through Drexel last year. Other Drexel beneficiaries: Boone Pickens, the Belzberg family and Ivan Boesky, who together raised more than three-quarters of a billion dollars. Takeover sharks like Irwin Jacobs, James Goldsmith and Asher Edelman, with records of successful stock raids, have no trouble raising money, either. These people don't need to raise all the money necessary to pay for a whole company. They just need enough for a credible stake, so they can extract greenmail money or put the target in play for another company to buy. Boone Pickens has become so adroit that he can play two big oil companies at once. First he went after Phillips. After negotiating a separate peace, under which his investor group got the right to sell its shares back to Phillips for $53 a share plus $25 million in "expenses," equal to another $2.80, Pickens moved on Unocal. He said he had bought 7.9% of the company for $584 million and planned to spend up to $616 million more. Where would Pickens and his investor group get $1.2 billion? From the loan commitments they originally obtained to buy Phillips stock.

Without cooperation from the banks, all this would not have evolved. Banks practically throw money at takeover deals because acquisition loans carry high rates and fat fees at a time when bank profits are under pressure. Banks have lost most of their cheap deposits because of deregulation and are loaded with expensive money market accounts and other high-cost funds. Profit margins on most loans to big corporate borrowers are paper-thin because these companies can threaten to bypass the banks with commercial paper. But takeover financ-



†Dome later traded its Conoco shares and $245 million for Conoco's Hudson Bay Oil & Gas holdings

Source W.T. Grimm & Co.

ing and leveraged buyout loans are lucrative.

Inadvertently, the 1981 Economic Recovery Tax Act helped fatten the corporate victims for the knife. The act was designed to spur economic expansion by allowing companies to take ultrarapid depreciation. One result was that cash flow grew faster than reported earnings. Unimaginative analysts and naive investors failed to see that this was strengthening the quality of corporate earnings; the sharp-eyed takeover artists quickly grasped the meaning. Because the extra cash wasn't reflected in earnings, ERTA didn't give stock prices an upward push. But by increasing cash flow, ERTA made corporate assets better collateral for takeover loans.

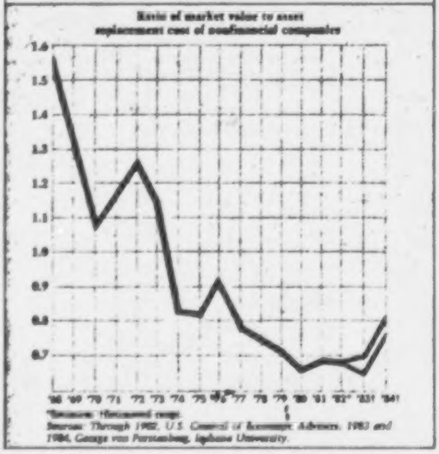
This last insight comes from SEC Chairman John S.R. Shad, formerly a top-notch corporate finance man at E.F. Hutton. "There's a differential between what people can justify paying for 100, 1,000 or 10,000 shares of stock and the value of taking over the entire company," he says.

The tax act so increased corporate cash flows that many companies now sell at "low multiples of their real cash flow and their ability to service debt," Shad adds. "They have substantial untapped borrowing capacity, which allows acquirers to finance a substantial part of the acquisition price against the acquisition itself." Hence also the recent phenomenon of leveraged buyouts—which are simply another form of takeover.

Even the extra cash flow wouldn't have allowed takeovers of giant companies four or five years ago, because few people on Wall Street had the experience and expertise to handle billion-dollar acquisitions. Today, it's different. The Street, ever fee-hungry, has brought forth lawyers and investment bankers to handle ever-larger deals. And, naturally, to knock down ever-growing fees. Salomon Brothers got $29.6 million in the Gulf deal, Morgan Stanley got $16.5 million and Merrill Lynch got $18.9 million. Kidder, Peabody got $15 million when Carnation was sold to Nestlé. Goldman, Sachs got $18.5 million in Getty's sale to Texaco, the same deal in which First Boston Corp. got $10 million for four days' work.

Assets for sale

In 1968, with stocks worth an average of 1.5 times assets, acquisitions were made with stock. The current takeover wave began in 1974. It's easy to see why.



*Estimate. †Horizontal range.
Sources: Through 1982, U.S. Council of Economic Advisers; 1983 and 1984, George von Furstenberg, Indiana University.

"People have learned to do things quickly," says Charles Nathan, managing director of strategic services at Merrill Lynch Capital Markets, who worked on his first merger deals as a young associate in the Wall Street law firm of Cleary, Gottlieb, Steen & Hamilton in 1968. "I remember negotiating an acquisition where the burning issue was whether the seller could provide us with a list of all the leases, including the ones on the typewriters," he says. "Now people are making multibillion-dollar decisions on the basis of nothing but public information. It used to take weeks to line up bank commitments. Now it can be done in just a few days."

Ten years ago First Boston Corp.'s mergers and acquisitions department consisted of 4 people and a telephone. Today it has 110 people. At the New York law firm of Skadden, Arps, Slate, Meagher & Flom, takeover business has tripled in the past ten years, and the number of partners working on it has doubled. Hungry, smart, highly paid people sit around all day doing deals or dreaming them up. This is where the action is. "There's a fever," says Martin Sikora, editor of *Mergers & Acquisitions* magazine. "Up until a few years ago M&A was an opportunistic thing. Now companies have long-term strategies to grow by making acquisitions."

It was less than six years ago that IBM sold the first $1 billion issue of corporate bonds, amid worries that the market couldn't absorb such a huge offering; today Drexel Burnham floats $1.3 billion of junk bonds for Metromedia, and no one blinks. Until 1975 there had been only one billion-dollar corporate acquisition in history, Xerox' purchase of Scientific Data Systems in 1969. There have been 40 in the past four years, 17 of them last year alone. Even taking inflation into account, last year was the biggest ever for the dollar amount of acquisitions, exceeding the previous high set in 1968 *(see chart opposite page)*.

The current merger wave, the fourth since the late 1890s, began in 1974 when old-line International Nickel Co., advised by old-line Morgan Stanley & Co., successfully raided another old-line industrial company, ESB. (Inco won, which is to say it lost, and ended up losing a lot of money, but that's another story.) If stodgy Inco and Morgan Stanley could do it, then hostile takeovers had become respectable.

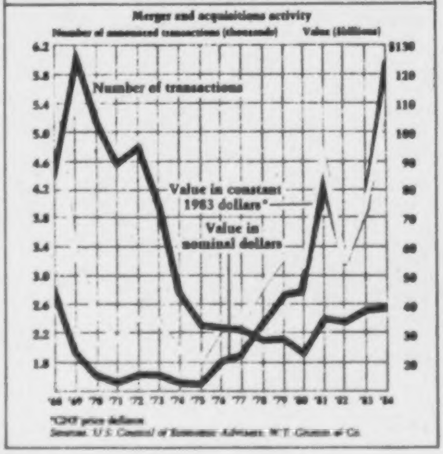
When the wave started, companies such as United Technologies used acquisitions to expand more quickly and cheaply than they could by building businesses from scratch. By comparison with what is happening today, that was a reasonably respectable motive. In recent years much of the activity has changed from cheap expansion to quick asset liquidation and to companies trading businesses. CIT Financial and Utah International have both changed hands twice. Esmark bought Norton Simon and sold businesses to help pay for it, then sold itself to Beatrice Corp., which is selling businesses to help pay for buying Esmark.

The previous merger waves were from 1896 to 1904, when monopolies like U.S. Steel and Standard Oil were formed in reaction to the Sherman Act, which outlawed trusts but not monopolies, from 1919 to 1929, when companies like General Motors, Swift and Pullman bought up suppliers and expanded horizontally, and from 1960 to 1969, when conglomerates used their overpriced stock to buy other companies and manipulate their earnings.

Raiders argue that today's deals take place because of the disparity between what they are willing to pay for assets and the meager profits that incompetent corporate managers earn from them. In some cases, the argument that a low stock price-to-asset ratio reflects bad management is compelling. But almost all stocks carry lower P/Es than they used to. The average P/E of the Standard & Poor's 500 is now 11, compared with the 18 that it was 20 years ago. Have the managers all gotten 40% less competent since 1965? Did Inco's takeover make ESB a better company or a worse one? Did Mobil make Montgomery Ward better or worse? One needn't be a close student of business to realize that these takeovers resulted in worse management, not better.

Counting the deals

Today's takeover lunacy involves fewer deals than earlier periods of excess, but far more money. Even counting inflation, 1984's dollar total topped 1968's.



*GNP price deflator.
Sources: U.S. Council of Economic Advisers; W.T. Grimm & Co.

To the extent that the leadership of American business is deficient in zeal and ability, the takeover artist is a questionable replacement. The leading predators like to portray themselves as champions of the shareholder and enemies of slothful management. But this pose is so self-serving as to be ridiculous. If many stocks still sell at low multiples compared with previous years, the reason is much more likely a consequence of high interest rates rather than of lousy management. With long-term interest rates running double the level they were at 20 years ago, why should any rational investor pay as much for a dollar of corporate earnings as he was willing to pay when rates were at 5% or 6%?

High interest rates lower the value of a dollar of earnings. At the same time, the inflation of the 1970s was steadily increasing the value of a dollar of assets. Earnings—what most investors react to—were worth less, while the underlying assets were worth more. The situation was ready-made for raiders and liquidators who knew how to buy on the basis of earnings and how to sell on the basis of assets.

In any event, totally awful companies are rarely taken over. "When you're an ugly girl, no one pays attention to you," says John Norell, president of Phillips' biotechnology subsidiary. "Then she gets herself in shape . . . and the first thing that happens is, somebody rapes her." As a result, companies are sometimes led to doing perverse things to avoid rape. They may overpay for an acquisition in order to make themselves less sexy to potential rapists. Or they may load up their balance sheet with debt to make themselves less attractive.

"The whole game is nauseating," says Andrew Sigler, CEO of Champion International and chairman of the Business Roundtable's corporate responsibility task force. Sigler, whose company recently became the biggest paper company in the world by acquiring thrice-greenmailed St. Regis Corp., complains that whenever he expands Champion's capacity, he's deluged with complaints that all he cares about is making paper, not making money for his shareholders.

"The problem is deciding who the hell the corporation is responsible to," he says. "I can't ask my shareholders what they want. Champion is 75% owned by institutions, and my shareholders change so damn fast I don't even know who they are." And, he adds, "We're owned by a bunch of index funds. Who votes for an index fund? Some damn mathematical formula votes your stock."

Once a company is attacked, it is all but doomed to lose its independence if the raider succeeds in putting his offer into effect, because money managers, who control two-thirds of U.S. stock trading volume, tend to take the money and run.

Smile, then, when one of these raiders proclaims himself an apostle of shareholder value. They claim they want to help the target company's shareholders maximize returns. But when the target company pays greenmail—and the raider, naturally, accepts it—it is the shareholders the raider professes to care about who ultimately pay the bill. If a company is taken over and liquidated at immense profit, didn't that profit belong rightly to its shareholders? The idea that most of these raiders are out to maximize value for anyone other than themselves is ludicrous.

A FORBES study suggests that patient investors can be better served by having a tender offer fail rather than succeed. We studied 39 cases assembled by Kidder, Peabody & Co. (which specializes in tender defense) in which companies defeated hostile tender offers and remained independent. We compared what stockholders earned by holding these stocks through the end of 1984 (or until another bidder bought the company) with what they would have earned had the tender been successful and the proceeds reinvested in the S&P's 500 Index.

In 17 cases the target company's stock outperformed the index, sometimes by 3 or 4 to 1. So in almost half these cases, money managers would have maximized profit by holding shares rather than tendering them. We chose cases at least two years old to give the target stocks a reasonable period to make up lost ground, compared with what the tender offer would have yielded *(see table, p. 139)*.

But few CEOs can ask shareholders to reject a tender offer and wait for two years. In the meantime the question that plagues hundreds of conscientious chief executives is the question asked on our cover: Is there no escape from these people?

To beat takeover artists to the punch, CEOs can do what raiders would do: sell off real estate that's undervalued on the books or recover the surplus from overfunded employee pension funds. Those are probably good long-term strategies, regardless of whether a company is a target. In fact, many of the mergers that have been financially successful involved one corporation asset-stripping the other *(see box, opposite)*.

This liquidating of assets is part and parcel of the deindustrialization of America. Things are changing so fast these days that a CEO who doesn't do these obvious things—distasteful as they may be—can find himself thrown out and an acquirer buying the company and liquidating these assets to his personal profit, rather than for the benefit of the shareholders.

CEOs who feel that their shares are undervalued can leverage the company or liquidate all or part of it themselves, giving the profit to their shareholders rather than allowing a raider to seize it. Classic examples are Teledyne, which has periodically borrowed money to offer shareholders a chance to sell at an above-market price, IU International, which spun off its Echo Bay gold mine to its shareholders, or Masonite, which distributed its timberlands to its shareholders.

Many companies contend that the need to keep stock prices up forces them to take short-term approaches to their business. Their argument is that the Carl Icahns and Irwin Jacobses are turning this country over to the Japanese, who lack such predators.

But it's not as if corporate managers all thought long term until 1981, when big companies began to fall prey to raiders in record numbers. CEOs have been happy to base bonuses on short-term results, to reward money managers and employees for what they did in a quarter, to eschew long-term investments because they can't earn some mystical "hurdle rate" that is double or triple what the company as a whole earns. In other words, many companies are vulnerable to the predators precisely because they have managed for short-term results for too long. Companies like IBM, which managed for the long term, have little to fear.

"If you take a list of the best-run companies, they typically make long-term commitments, and they sell at decent multiples," says Frederick Joseph, head of Drexel Burnham's corporate finance department. "IBM is not a target. ITT is a target, because it hasn't managed its businesses very well. So ITT is complaining that it can't plan long term because of the sharks."

Rather than worrying about maximizing return on investment or long-term prospects, many companies take the easy way out—they pay off predators to go away. You can't blame predators for taking the money and acting like predators—they're not public charities, they're in business to make money any way they can, short of breaking the law. Blame the companies making the payoffs. But as the late Neville Chamberlain found out, appeasement doesn't work. Hitler promised to behave if they would let him take the Sudetenland, but he came back later for Poland and France.

After a greenmail payment, a company's stock tends to plunge as takeover speculators bail out—and someone like Irwin Jacobs, with a shrewd eye for market overreactions, may well appear. Jacobs bought into Avco, Disney and

Maximizing shareholder value?

Conventional wisdom notwithstanding, a target's shareholders are often better off if a tender offer fails. We studied 39 cases in which companies successfully resisted hostile tenders. In 17 cases, the value of the target's stock at year-end 1984 exceeded what a shareholder would have if the offer had succeeded and the proceeds had been reinvested in the S&P's 500 Index. (Where a company defeated one offer but was later bought, our calculations run through the acquisition date.) So when managers call an offer for their company "inadequate," it's not always just to protect their jobs. We didn't include capital gains tax on the tender proceeds and didn't count cash dividends from the stock or the S&P's.

		How well you—would have fared—	
Company	First announcement date	holding stock through 12/31/84	investing proceeds in S&P's 500
Dictaphone*	Sep 1974	133%	33%
Inspiration Consol Copper*	Feb 1975	−16	17
Sterndent*	Feb 1975	61	49
Unitek*	May 1976	97	−7
Pargas*	May 1976	143	58
McKesson	May 1976	42	61
Sabine and Sabine Royalty Trust	Sep 1976	135	62
Universal Leaf Tobacco	Oct 1976	389	63
Viacom International	Jan 1977	225	73
Sunshine Mining	Mar 1977	36	69
Detroit Intl Bridge*	May 1977	25	14
Gerber Products	Aug 1977	51	73
Marshall Field*	Dec 1977	−29	24
Rowan Cos	Jul 1978	47	61
Mead Corp	Aug 1978	−2	62
Wurlitzer	Sep 1978	−85	73
Levitz Furniture	Nov 1978	172	73
Chicago Rivet & Machine	Jan 1979	−44	73
Mission Insurance*	Jan 1979	29	64
McGraw-Hill	Jan 1979	114	73
Ludlow Corp*	Feb 1979	45	18
Woolworth	Apr 1979	6	69
Hoover	May 1979	31	64
Harnischfeger	Jun 1979	−60	61
Morrison Inc	Jul 1979	−3	56
Telecom Corp	Aug 1979	−87	54
Gulf Resources	Feb 1980	−70	64
Harsco	Jan 1981	26	47
Amax	Mar 1981	−79	26
Canal-Randolph (in liquidation)	May 1981	229	29
Posi Seal Intl	Jun 1981	−32	28
Heinicke Instruments	Jul 1981	−14	36
Wetterau	Aug 1981	19	43
Grumman	Sep 1981	21	37
Maxxam Group	Oct 1981	11	33
Brunswick	Jan 1982	352	48
SCA Services*	Mar 1982	99	42
RP Scherer*	Jul 1982	48	44
Martin Marietta	Aug 1982	39	37

*Acquired before 12/31/84, results through acquisition date

Everyone is preparing for the takeover wave to go on forever, but it won't. The market created these raiders, and market forces will ultimately make them go away.

Castle & Cooke after they were greenmailed but hasn't taken any greenmail himself. "I think greenmail is terrible," he says, "but if it's not stopped, I'm going to do it. . . . My objective is to make money." The sad thing is that it would be so easy to stop greenmail. Just pass a law forbidding companies to make any offers to big stockholders that they don't offer to all their stockholders.

So far, according to statistics compiled by Kidder, Peabody, five companies have adopted antigreenmail charter amendments, and about 60 more will probably have them in place by the middle of this year. Last year alone, 250 companies installed various antitakeover provisions. Everyone is preparing for the takeover wave to go on forever.

But it won't. The House, Senate and SEC are all holding yet another set of hearings on takeovers. Previous reform attempts produced only minimal changes such as taxing some "golden parachute" payments. Now the business establishment is after major revisions. "The people in the merger business want to modify the rules by taking out the nauseating things like golden parachutes and scorched earth defenses," says Champion's Andy Sigler. "They don't want to stop the game. That's how they make their living."

Even if Congress does nothing about takeovers, the market may. Some takeovers seem in financial trouble. For one, Victor Posner's hostile buyout of Royal Crown resulted in missed bank loan payments, since made up. One or two horrible failures will cut back bank takeover money in a hurry. The proposed tax law changes would lower corporate tax rates to 33% from 46%, decreasing the value of interest deductions, and would greatly reduce the 1981 tax breaks.

Moreover, the stock market is strong. And with inflation having subsided to low levels, no longer do asset values increase 10% a year automatically. As stock prices more closely reflect basic asset values, the predators will lose their easy prey.

No other major merger wave has gone on for more than ten years. This one is already well advanced. We suspect that just as they begin to look unstoppable, the financial raiders will either disappear from the scene or metamorphose into conventional businessmen. ■

Mortgaging the future

When companies start worrying about sharks, practically the last thing they care about is tomorrow. As a result, one of the first items to go in corporate restructurings is the R&D budget. Long-range planning is pushed to the back burner when companies attempt to thwart current takeover attempts, according to Michael Heylin, editor of *Chemical & Engineering News*, which is published by the American Chemical Society. Aside from the scientists and engineers who are laid off, R&D dilution demoralizes everyone in a company because they suddenly realize that long-range thinking and planning have gone by the board. Consider: Between June 1982, just prior to the first assault on the company by T. Boone Pickens, and now, Gulf Corp. throttled back operations including its research and development. According to one source, a substantial number of its scientists and engineers have been laid off. Did it help? Chevron Corp., which took over Gulf in June of 1984, has continued the cuts. Gulf's once-respected research institute, in Harmarville, Pa., will probably soon be sold or donated to the University of Pittsburgh.

The case is much the same with Phillips Petroleum. In opposing Boone Pickens and Carl Icahn, Phillips came up with a refinancing and asset sale scheme designed to produce at least $2 billion. To raise that money, says John Norell, president of Provesta Corp., Phillips' biotechnology subsidiary, research expenditures have been slashed by 75%, from more than $20 million to $5 million. While no scientists have yet been laid off, Norell says that substantial numbers of scientific and technical jobs would be threatened if assets were sold. In addition, advanced research projects already on the drawing boards, such as a $15 million dry yeast protein plant in Nebraska, have been scrubbed, and the company is scaling back on venture capital commitments made to fledgling companies.

At a recent meeting of the Industrial Biotechnology Association in Fort Lauderdale, Norell made it clear to companies such as Biogen, Cetus and Genentech, which are now looking to the oil and chemical giants as joint venture partners: "It won't be easy to walk into a large company to get money. For the short term, spare cash in our industry is going toward the redeployment of existing assets."

Why would any company in its right mind do away with R&D in an increasingly competitive environment? Says Norell, "Everybody figures, hell, let's just get past today. Research is intangible, and there is little way we can prove that it benefits the company immediately. So we can save money by firing the scientists, and when this is all over we can just hire them back."

But it isn't that simple. Work in progress that is suddenly terminated is often superseded by more advanced research elsewhere. So what appears to be a short-term savings turns out to be not a long-term but an almost immediate loss.—**Stephen Kindel**

A Study

by

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September 7, 1984

Shark Repellent: The Role and Impact of Antitakeover Charter Amendments

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The views expressed herein are those of the Office of the Chief Economist only. The Commission has expressed no view on this study.

Shark Repellants: The Role and Impact of Antitakeover Charter Amendments

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Corporate control battles have taken many forms. The role of antitakeover charter amendments -- whether they benefit shareholders or management -- has not yet been determined. However, their increasing prevalence on shareholder ballots has led to strong interest in determining the impact of these amendments on shareholder wealth.

In this study, we take a large sample of firms proposing antitakeover amendments and consider the impact of these amendments on share prices. We include 131 New York or American stock exchange firms and 40 firms traded over the counter. All of these firms introduced successful fair price amendments, most of which included supermajority provisions.

We find evidence which supports the hypothesis that antitakeover amendments reduce shareholder wealth. From forty trading days before through the mailing date of the proxy detailing the amendments, we find that shareholder wealth decreases an average of approximately three percent for 87 NYSE or ASE firms at the proposal of fair price combined with supermajority proposals. In dollar terms, the shareholders of these firms lost about $1.13 billion in capital value, according to these results. The 40 OTC firms suffered an average loss of nearly 5 percent in the time period around their proxy mailing dates. This implies a dollar loss of another $250 million. Therefore, the aggregate loss to shareholders of these 127 NYSE, ASE, and OTC firms resulting from passage of anti-takeover amendments is estimated to be about $1.35 billion.

In this memorandum, we first review the controversy. Arguments detailing the potential benefits and harms of anti-takeover charter amendments are outlined. We then turn to the question of why shareholders would vote for these amendments if they are, in fact, harmful to shareholder wealth. Our empirical work follows in which we more completely report our results.

I. Hypothesis One: Antitakeover Charter Amendments Benefit Shareholders

The fact that shareholders vote for these amendments suggests that they perceive some good in them. Several possible benefits have been suggested by various writers. If we assume that these amendments lower the probability of a takeover contest in the firm introducing them, then the firm may benefit by protecting their management team from abrupt dismissal. Managers may be more likely to engage in longer-term investment projects which do not have an immediate payoff. These longer-term projects may ultimately be more profitable, but shareholders may not be able to identify those potential profits as well as the managers. Under this scenario, protected managers would be more likely to choose the "correct" investment, with less worry about short-term stock price reaction.

An alternative suggested benefit from antitakeover amendments is based on the premise that management tries to protect its job. To do that, there are several alternative steps they may take. Defensive actions may include antitakeover amendments, payment of greenmail to potential bidders, standstill agreements, contracts for asset sales which would decrease the firm's value in the event of a takeover bid, or any number of other procedures devised by creative managers and investment bankers. Of all the possible protective maneuvers, some suggest that antitakeover amendments are the least costly to the firm's shareholders. Thus, antitakeover amendments benefit shareholders because they discourage alternative, more costly maneuvers.

Though these two explanations have validity, economists suggest a third rationale for why shareholders would approve takeover amendments. This explanation relies on individual incentives to tender to an offer even if a better offer might be forthcoming. That incentive to accept a relatively low offer is founded on the fear that if the offer is accepted by over 50 percent of the shareholders, a non-tendering shareholder will be forced to accept a lower price than what might have been ultimately offered. That is, an individual shareholder will accept a price which he believes is not high enough because he fears at least 50 percent of the other shareholders will accept the offer. Because each shareholder expects the same of every other shareholder, the offer is accepted. 1/

Some proponents of antitakeover amendments suggest that these amendments alter the situation. In any wealth-increasing combination of two firms, the sharing of the wealth between the two firms must be determined. 2/ The bidding firm will want to to capture a large portion of the wealth increase by purchasing the firm at a relatively low premium. The target firm will want to capture as much of the wealth increase as it can by forcing the highest possible bid. Under certain conditions, the target managers can benefit their shareholders by acting as their central negotiating agent (as they do for merger negotiations).

Consider an example. Suppose Company A and Company B would experience a $1 million increase in wealth if they were to combine. This wealth increase might be due to complementary production techniques. Company A makes a bid for Company B's

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1/ DeAngelo, Harry and Edward M. Rice, "Antitakeover Charter Amendments and Stockholder Wealth," The Journal of Financial Economics, 1983, Vol. 11, pp. 329-361.

2/ Bradley, Desai, and Kim, "The Rationale Behind Inter-firm Tender Offers: Information or Synergy?" The Journal of Financial Economics, 1983, Vol. 11, pp. 183-206.

10,000 shares. They should be willing to pay up to a $100 premium for each of those shares, for a total premium payment of $1 million. However, they would prefer to pay a $1 premium. Company B's shareholders would prefer to receive a $100 premium but even a $1 premium leaves them better off than they were before.

The size of the premium received by Company B's shareholders will be determined by the relative bargaining strengths of the two companies. Company A's position is stronger the fewer the number of firms which may make competing bids. (That is, the fewer the number of firms that would benefit in a similar manner from a combination.) Company B's position is stronger the more cohesive the shareholders are in determining a response to any particular bid.

In effect, antitakeover amendments in general, and supermajority provisions in particular, can force shareholders to act in a more cohesive manner. Because shareholders know a bid will only be accepted in the case where 66-2/3 to 90 percent of the shareholders accept the offer (as in the case of supermajority provisions), they have less to fear by not tendering to any specific offer which they may think is too low. The probability is reduced that any offer will be accepted without the holder's shares. In the end, Company B's shareholders may be able to extract a higher premium if they can act in a cohesive manner. (However, it is also possible that the prospect of paying a high premium could deter a bidder from attempting a takeover.)

Thus, it is argued by some observers that shareholders may gain from the passage of antitakeover charter amendments. Shareholders may benefit by providing their managers with a stronger bargaining position with potentially hostile bidders. Management may benefit from the ability to focus on longer-term projects. Also, fewer firm resources may be spent on alternative protective devices.

II. Hypothesis Two: Antitakeover Charter Amendments Hurt Shareholders

Shareholders, many others argue, are hurt by antitakeover amendments. Substantial literature exists which verifies that target shareholders receive large premiums from tender offers and merger agreements. If antitakeover amendments are successful in discouraging tender offers or mergers, then shareholders may lose substantial benefits as a result of these amendments.

The potential costs of antitakeover amendments, however, are not limited foregone premiums. Antitakeover amendments may lead to "management entrenchment". Management's job protection is increased and its decisions may be less closely linked to responsibilities towards shareholders. A long-noted problem in public companies is the separation of ownership by shareholders from control by management. Several mechanisms work to discipline managers to ensure that their goals are analogous to those of shareholders. These mechanisms include: 1) contracts between shareholders and management, such as compensation plans which are tied to managerial performance -- as in bonus or stock option plans, 2) managerial labor market forces which lower future potential wages for poor managers and 3) the threat of the loss of management's jobs through shareholder vote, such as through a proxy fight or a sale of the firm to new owners.

Antitakeover amendments reduce managerial discipline by this theory. The cost to shareholders of voting out existing management increases substantially. Management is allowed to be more self-serving in its actions than before the amendments and are better insulated from takeovers and proxy fights if they fail to maximize the value of firm equity.

III. Why Do Shareholders Vote for Antitakeover Amendments?

If our first hypothesis is true that shareholders benefit from antitakeover amendments, then it is clear why shareholders approve them. Firms which pass antitakeover amendments would be better off as a result. For some reason, these firms would especially benefit from long-term job protection for management or from efficient antitakeover maneuvers. Or, they are firms which perceive a special need to act cohesively on corporate control questions. Identifying why this set of firms find these amendments especially beneficial is beyond the scope of this study. However, if the first hypothesis is true, it is not surprising that shareholders approve these amendments.

The more difficult question arises when one asks why shareholders would vote for amendments which harm them by reducing the likelihood of premium opportunities from tender offers and by increasing costs of managerial discipline. This difficult question arises if our second hypothesis were true.

Two possible explanations for perverse voting behavior have been suggested. 4/ Both of these rest on the premise that certain shareholders perceive that the cost of voting against the amendments exceeds any benefit from voting for them. The first explanation suggests that there is a group of investors which gains by working with incumbent managers. These investors would probably take the form of institutional investors who hold large blocks of stocks. If these holders expect future consideration from incumbent management as a result of their votes in favor of antitakeover amendments, they may gain more than any resulting loss in share value.

The alternative explanation again rests on two classes of voters. DeAngelo and Rice call these voters "informed" and "uninformed". Informed voters (perhaps institutional holders) will carefully assess the amendment and vote against it if they expect it to hurt share value. In contrast, the uninformed voter has relatively high information costs of determining the impact of the amendment on his wealth. The uninformed voter may find that in general his wealth is maximized by agreeing with management when it solicits proxies, rather than always expending resources to predict the effects himself. Thus, he accepts the antitakeover proposal even when informed shareholders recognize its detrimental effects. The informed shareholder

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4/ A third possible explanation is that shareholders are irrational. Though this explanation may be attractive to some, there is no theoretical or empirical basis for it.

could introduce a proxy fight. However, the substantial costs involved would have to be less than the loss in share value. It should be noted that both the first and second explanation rest on the assumption that the group voting for the antitakeover amendment holds a majority position.

IV. Data and Methodology

A. Sample

Kidder Peabody provided us with a list of firms proposing fair price amendments from the period 1980 through 1983. Though the list probably does not include all proposed fair price amendments, we believe that the 171 firms listed are representative of all fair price amendments during this period. Of these firms, 131 are traded on the New York or American stock exchanges, and the remaining 40 are traded over the counter.

Fair price amendments are designed to protect minority shareholders after a bidder has acquired a large block of shares. It is feared that a large holder could "squeeze out" the minority, forcing them to accept a low price. In general, fair price amendments require the bidder to pay minority shareholders at least as much as the highest price paid to acquire shares already held. More detailed provisions may tie the price to market value of the firm or price-earnings ratios and earnings per share.

Of the 131 NYSE or ASE firms proposing fair price amendments, 87 included supermajority provisions. Supermajority approval provisions require a greater than 50 percent approval by shareholders for transactions such as mergers, liquidations, dissolutions, or sale or lease of major assets. Required shareholder approval of these transactions may range from 66-2/3 to 90 percent, and in general require a similar percent approval of the amendment itself. Most of the 40 OTC firms included supermajority provisions also.

A problem with interpreting our results is that we do not account for the many other factors that could cause changes in firm value simultaneously with public announcement of antitakeover proposals. For example, in their study of 265 antitakeover amendment proposals from 1974-1979, DeAngelo and Rice identify 144 cases where a "confounding event" may have occurred. These confounding events include changes in number of authorized shares, changes in managerial incentive plans, changes in state of incorporation, simultaneous removal of other antitakeover provisions and changes in voting rights. However, because we consider a large number of tender offers, we hope that our lack of identification of potential confounding events will "wash out" in our results. 5/

Data on net-of-market stock returns for the NYSE and ASE firms are obtained from the CRSP (Center for Research in Security

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5/ It should be noted that the two samples used by DeAngelo and Rice - the "clean" sample and the larger one including the confounding events - both yield nearly identical results on the average net-of-market stock returns during the announcement period.

Prices) data file. We compute stock returns for OTC firms from the ISL tapes, and employ the standard market model to net out the effects of general market movements on gross stock returns.

B. Event Date

In any study of market reaction to a particular event, the date at which market participants become aware of the event must be identified. In this study, we could choose from several potential dates. Bhagat outlines these choices. 6/ The earliest date at which the market might become aware of an event such as the proposal of an antitakeover amendment is when the board of directors of the company approves the amendment. However, Bhagat notes that proposed charter amendments are rarely reported in the financial press and this information is known only to corporate insiders.

The second date at which market participants may become aware of proposed amendments is the date on which proxies describing the amendments are mailed. At this time, the proposal is public knowledge. A third possible choice for a date at which a proposed amendment would affect the price of a firm's security is the date of the shareholder meeting at which the amendment is voted on. However, it is probable that at the time the proposal is voted on, market participants have already assessed a high probability that the amendment will pass and

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6/ Bhagat, "The Effect of Pre-Emptive Right Amendments on Shareholder Wealth", The Journal of Financial Economics, 1983, Vol. 12, pp. 289-310.

the security price will reflect that information.

We choose the proxy mailing date as the event date for our study. It is at this time that the market learns of the proposed amendment on a widespread basis. At an earlier date, only a few insiders would be aware of the information. At a later date, the security price would already reflect the high probability of the passage of the amendment. Our approach is consistent with that of Bhagat, Linn and McConnell, and DeAngelo and Rice. 7/

Of course, the proxy mailing date will not be perfectly correlated with the date at which the market becomes aware of the proposed amendments. The firm may issue advance announcements or the information may be leaked in one form or another. Thus, we rely on a large sample of announcements to minimize individual error in identifying the announcement date. Also, we look at stock returns from 40 trading days before the proxy mailing date through two days after to determine the overall impact of the proposed amendments. Other events affecting security prices may fall in this 43-day period -- again, we rely on averages over large samples to wash out these possible fluctuations.

C. Estimation Procedure

The relationship between each security price and the market index is estimated over a control period preceding the proxy

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7/ Linn and McConnell, "An Empirical Investigation of the Impact of 'Antitakeover' Amendments on Common Stock Prices," The Journal of Financial Economics, 1983, Vol. 11, pp. 361-400.

mailing date. This estimated relationship is then used to predict what security prices would be if they continued to track the market in the same manner. Predicted stock returns are compared to actual returns to determine if the stock performed unusually well or badly in the prediction period.

In effect, this procedure uses the estimated relationship between an individual security and the market to "net out" overall market influences from security prices. Thus, we look at the period 40 trading days before through two days after the proxy mailing date to determine if the market perceives antitakeover amendments in a positive or negative light.

V. Empirical Results

If security prices of firms proposing antitakeover amendments appreciate significantly, net of market influences, over a period surrounding the announcement of those amendments, then the evidence supports the first hypothesis that antitakeover amendments benefit shareholders. However, if we observe a significant depreciation in share value during the announcement period, then the evidence supports the second hypothesis that antitakeover amendments hurt shareholders. Though we can not make conclusive statements about the validity of either hypothesis due to our lack of analysis of all possible confounding events, we can learn substantially the general effects on stock value of these antitakeover proposals and compare them to the work of other researchers in this area.

Our results are summarized in Table 1. In our sample of

TABLE 1

The Effects of Antitakeover Charter Amendments On Net-of-Market Stock Returns, For NYSE, ASE, and OTC Firms, 1980-1983.

Sample of Firms[1]	Average Net-of-Market Change in Stock Price (in Percent)[2]	Level of Statistical Significance[3]
131 NYSE and ASE Firms Proposing Fair Price Provisions, 1980-83.	-1.78	1.46
87 NYSE and ASE Firms Proposing Both Fair and Supermajority Provisions, 1980-83.	-3.09	2.22
40 OTC Firms Proposing Fair Price Provisions, 1980-83, Measured over -40 to +2.	-2.11	1.22
40 OTC Firms Proposing Fair Price Provisions, 1980-83, Measured over -40 to +10.[4]	-3.38	2.41
40 OTC Firms Proposing Fair Price Provisions, 1980-83, Measured over -40 to +20.[4]	-4.92	2.44

Notes to Table 1:

1. The firms in this sample are selected from a survey by Kidder Peabody of firms proposing fair price provisions between 1980-83. We used a Drexel Burnham survey of firms proposing supermajority provisions between 1980-83 to determine which firms passed both types of provisions. Note that the 87 firms proposing both provisions constitute a sub-sample of the 131 firms that proposed fair price provisions. We presume that all of the firms passed these charter amendments.

Table 1 continued:

2. These are cumulative net-of-market stock returns averaged over all of the firms in the particular sample over the interval -40 to +2 (unless otherwise indicated) relative to the proxy mailing date. The net-of-market returns are computed using the standard market model, which employs each firm's historically determined "beta" measure to net out the effects of general market movements from the firm's gross stock returns.

3. This measure is a t-statistic (in absolute value). Levels above 1.96 provide greater than a 95% confidence level that the estimated average change in stock price is different than zero.

4. We include results from expanded intervals for OTC firms because of the observed continued drift in stock prices after the proxy mailing date. There is no analogous drift in the NYSE and ASE sample.

131 NYSE and ASE firms, we find that shareholders lose, on average, 1.78 percent of the value of their shares during the period 40 days before through two days after the proxy mailing date. This result is of borderline statistical significance, although the mean effect is of non-trivial magnitude.

Though we are unable to strictly determine which type of antitakeover amendment is more restrictive than another, it should be true that either type of amendment would affect share prices in the same direction; that is, both should either increase shareholder wealth or decrease shareholder wealth. In 87 of the 131 NYSE or ASE firms, supermajority provisions were proposed at the same time as fair price amendments. These firms experienced an average 3.09 percent decline in share value, significantly different from zero at the 97.5 percent probability level. In dollar terms, this represents a $1.13 billion loss to shareholders.

Thus, if a supermajority provision is combined with a fair price amendment, the loss to shareholders is much greater than if a fair price amendment is introduced by itself. In fact, the evidence suggests that fair price amendments by themselves have little effect on security prices.

Similar returns are determined for 40 OTC firms. Again, the evidence suggests that antitakeover amendments hurt target shareholders. From 40 days before through two days after the proxy mailing date, share prices of these 40 firms depreciate an average 2.11 percent. For a longer period, 40 days before through 20 days after the proxy mailing, share prices drop an average 4.92 percent. In dollar terms, these OTC firms lost $216 million as a result of proposing antitakeover amendments, according to our results.

Conclusion

This memorandum presents evidence that the proposal of antitakeover amendments to corporate charters is harmful to shareholders. The average net-of-market stock price decline for 87 NYSE and ASE firms that proposed fair price and supermajority provisions from 1980 through 1983 is over three percent, from forty trading days before to two trading days after the proxy mailing date. The average net-of-market stock price decline for 40 OTC firms that proposed similar antitakeover amendments from 1980 through 1983 is nearly five percent. (Both of these results is statistically significant at the 95% confidence level.) The average stock price declines over these 127 firms implies an aggregate capital loss to shareholders of about $1.35 billion.

While these on-average price declines are consistent with isolated cases of beneficial antitakeover amendments, the aggregate data support the general conclusion that these amendments are perceived by the market as devices to entrench incumbent management. This interpretation of the evidence perhaps explains the reported growing hostility towards these amendments by institutions and other sophisticated, outside stockholders. It remains puzzling, however, why such large numbers of public firms receive shareholder approval for antitakeover amendments.

A Study

by

The Office of the Chief Economist
Securities and Exchange Commission
450 5th Street, NW.
Washington, DC 20549

September 11, 1984

The Impact of Targeted Share Repurchases (Greenmail) on Stock Prices

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The views expressed herein are those of the Office of the Chief Economist only. The Commission has expressed no view on this study.

The Impact of Targeted Share Repurchases (Greenmail) on Stock Prices

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I. INTRODUCTION

Since January, 1979 about five and one-half billion dollars has been paid by firms to repurchase blocks of common stock from individual shareholders (or a particular group of shareholders). These payments represent an aggregate premium above market price of over one billion dollars. 1/ Many of these large premium payments clearly were made by target management to reduce the threat of losing control of the firm through a tender offer or proxy fight. The financial press has devoted considerable attention to the recent examples, such as Disney's repurchase from Steinberg, St. Regis repurchase from Goldsmith, and Warner repurchase from Murdoch. The term "Greenmail" is commonly used to describe these payoffs,

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1/ These figures are based on a survey by Kidder Peabody of common block repurchases from individuals from January, 1979 to March, 1984, with the addition of three recent 1984 cases (Disney's repurchase from Steinberg, Houston Natural Gas from Coastal, and Quaker State from Steinberg).

reflecting the widespread perception that this practice, or the process leading to it, is counter to the best interests of target shareholders.

In response to the Tender Offer Advisory Committee's recommendation, the Commission proposed legislation which would restrict the repurchase of more than three percent of outstanding securities at a price above the market price from any individual holder, unless shareholders approve the purchase. Blocks held for more than two years would be exempt from this requirement. The Commission would receive the authority to define other exemptions to avoid the burdens of a shareholder vote where necessary.

There has been much discussion among policymakers about the merits of the Commission's anti-greenmail proposal. A fundamental question has arisen about the empirical effects of targeted share repurchases on the wealth of non-participating shareholders. This memorandum gives evidence on the impact on share prices of targeted share repurchases.

The statistical analysis is based on a large sample of 89 cases of targeted share repurchases involving NYSE or ASE firms between 1979-1983. The evidence suggests that non-participating shareholders suffer substantial and statistically significant share price declines upon the announcement of targeted repurchases at premiums above market value. The overall impact on share prices from the date the initial foothold position is established to the date the block is repurchased is also negative. The appreciation in stock prices caused by the initial foothold acquisition is more than offset by the decline in stock prices in response to events subsequent to the initial acquisition, on average. This evidence is consistent with the findings of Bradley and Wakeman (1982) and Dann & DeAngelo (1983), but contradicts to some degree the findings of Mikkelson and Ruback (1984).

We conclude that the overall impact of targeted share repurchases on the wealth of non-participating target shareholders is negative. The stock price evidence indicates that the magnitude of the losses to non-participating target shareholders is at least equal to the wealth loss implied by the cash premium paid for the block repurchase. The losses are more severe in cases where there is evidence that the foothold acquisition and disposition was associated with a struggle for corporate control, such as a possible tender offer or proxy fight.

The next two sections present this evidence in more detail. Section IV continues by comparing the empirical implications of the various theories about greenmail with our results. We conclude that the payment of greenmail is not in the best interests of target shareholders, particularly when it terminates a contest for corporate control. This kind of evidence supports the Commission's approach of requiring a shareholder vote on these transactions, rather than erecting regulatory barriers to the initial formation of these control-oriented stock blocks. We stress that this empirical evidence standing alone cannot shed light on some of the other important questions surrounding this debate, such as the relative efficiencies of a Federal versus a state solution to this important problem.

II. The Effect of Greenmail on the Stock Price of the Target.

There are three periods of interest during the life cycle of a block of stock that is ultimately repurchased by the target firm. Each period has distinct effects on the stock price of the target. The most fundamental question concerns the net change in the stock price over all three periods.

1. Initial Establishment of Foothold Acquisition

The initial establishment of the block is signaled by a 13D filing with the Commission. This requirement is triggered when an individual acquires beneficial ownership of more than five percent of the outstanding securities of a public company. This disclosure is public, and for notorious entrepreneurs, such Icahn, Murdoch, and Posner, it is often the subject of newspaper reports.

2. The Interim Period Between Establishment and Repurchase of Stock Block.

The "Interim Period" is the duration between the initial establishment of the block and its repurchase by the target firm. During this period there is often great uncertainty about the target's value, as the market reacts to events that alter the relative likelihoods of a profitable takeover or effective defensive actions. The net change in the stock price during the interim period is critical to assessing the overall effect of targeted share repurchases on shareholder wealth. The long average duration of this Interim Period, however, causes these stock price measurements to possess less than maximum statistical precision, because other information important to valuing the target, but unrelated to the control contest, will be released during this long interval.

3. The Repurchase of the Stock Block (Greenmail)

The repurchase of the stock block by the target firm is reported quickly in the financial press for all of our cases. We measure the stock price reaction from five trading days before to five trading days after the press announcement. These reports almost always disclose the size of the block, the repurchase price and premium, and other noteworthy items. such as standstill agreements (obligating the seller to refrain from transacting in the target's stock for a specified time period) and settlements of litigation. It is also common for these reports to discuss how the repurchase apparently changes the likelihood of a takeover, a proxy fight, or some other activity related to the control contest.

4. The Selection of a Sample for OCE Study

OCE has collected data on 89 firms that made greenmail payments. The data primarily came from separate studies by Kidder Peabody and Merrill Lynch. The firms must have an announcement date of the original foothold acquisition by the targeted seller as well as a date for the repurchase agreement.

The announcement date of the original foothold acquisition is defined to be 1) the original 13D filing date, 2) the date the Wall Street Journal reported the foothold acquisition (usually just after the 13D date), or 3) the filing date of the 14D in the case of attempted tender offers. When more than one of these dates is available, we selected the earliest to be the relevant date.

The 89 firms in the sample also satisfy the following four requirements:

1) NYSE or AMEX listed,
2) Foothold established by the block-holder is potentially for control purposes,
3) Targeted repurchase block exceeds 3% of the outstanding common stock,
4) Repurchase is at a premium of at least 3% over the then prevailing market price.

III. Empirical Results

The changes in stock prices over the three critical periods is measured for each target net of the effects of general market movements. This is done with a widely-used statistical technique that i) measures the "normal" co-movement between the stock and the value-weighted market portfolio over an historical period and ii) using this "normal" relationship to net out the effects of changes in the market portfolio over the relevant test periods.

1. Appreciation During Initial Foothold Acquisition

The average net-of-market stock return for the 89 cases during the initial foothold acquisition is 9.7 percent (See Table 1.) This is measured from twenty trading days before to five trading days after public announcement of the acquisition. This large, positive return reflects widespread expectations that the acquisition of these stock blocks will confer substantial future benefits to shareholders. The specific sources of these benefits have been the subject of much research. 2/ They include takeovers, proxy fights, and closer monitoring that can cause various improvements in the utilization of the target's assets. The market must also assess the probability of non-beneficial outcomes, like greenmail or purely disruptive activities, perhaps designed to induce greenmail payments.

The large, positive appreciation around the intial acquisition means that the market places a much lower probability on these costly outcomes than it does on the beneficial outcomes. This is quite logical in view of the evidence that bad outcomes such as greenmail actually occur

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2/ As reported in an OCE Information Memorandum on Greenmail dated July 3, 1984, several other studies measure significant stock price appreciation during the period that these large block acquisitions are announced. Refer to Holderness and Sheehan (1984), Mikkelson and Ruback (1984), the OCE Study of well-known investors (1984), and the study by the Directorate of Economic and Policy Analysis on the costs and benefits of 13D filings (1983).

TABLE 1

The Net-of-Market Change in Stock Price for 89 NYSE and ASE Cases of Targeted Share Repurchases, 1979-1983, from Before Initial Foothold Acquisition to After Repurchase.

	All 89 Cases	Control Contests	Non-Control Cases
Return Around Initial Foothold Acquisition (-20 to +5)	+9.7%	+9.7%	+9.8%
Return During Interim Period (+6 After Foothold to -6 Before Repurchase)	-7.1%	-7.2%	-7.1%
Return Around Repurchase (-5 to +5)	-5.2%	-6.8%	-3.3%
Overall Return (-20 Before Foothold to +5 After Repurchase)	-3.7%	-6.0%	-1.1%
Percentage Cost of Repurchase to Non-Participating Shareholders	-3.6%	-4.7%	-2.3%

Statistical Notes to Table 1

i) The average block size is 12.6% of outstanding shares.
The maximum block size is 37.0% of outstanding shares.
The minimum block size is 3.9% of outstanding shares.

ii) The average repurchase premium is 20.9% of market price.
The maximum repurchase premium is 100.0% of market price.
The minimum repurchase premium is 3.2% of market price.

far less frequently than do beneficial outcomes. (See Sheehan and Holderness (1984)). Moreover, some of these beneficial outcomes, such as takeover outcomes, can confer very large gains to target shareholders. Therefore, the 9.7 percent appreciation accurately reflects the valuable contribution made to the other target shareholders from the active participation in the corporation's affairs by these large shareholders.

2. Depreciation During the Interim Period

The net-of-market returns are quite unstable during the interim period, because of the great uncertainty and the large stakes that accompany these control contests. The overall stock performance of these 89 cases, however, is negative during this period. The average net-of-market return is a negative 7.1 percent, and the average interim period spans about 280 trading days. The interim period is measured from six trading days after the initial foothold acquisition to six trading days before the repurchase announcement.

Therefore, most of the appreciation accompanying the initial foothold acquisition is lost for these cases during the interim period. This is easily explained by the nature of our sample - it is selected for bad outcomes. The market cannot distinguish very clearly at the time of the initial foothold acquisition these eventual greenmail cases from the other, more frequent cases of takeovers, etc. As time passes the information that distinguishes these different kinds of cases becomes more complete. Bidders fail to materialize and the target management raises staunch resistance to the blockholder's activities. This new information causes these 89 cases, selected using hindsight for their non-beneficial outcomes, to suffer significant declines in their stock prices.

3. Depreciation Upon Announcement of the Repurchase

The net-of-market stock returns in response to the public announcement of the stock block's repurchase at a premium is a negative 5.2 percent. This is in line with the results of Bradley and Wakeman (1983) and Dann and DeAngelo (1983). There are two reasons for this negative reaction to the repurchase agreement. First, the non-participating shareholders directly bear the cost of the payment that is made to the block seller. Given the magnitude of the payment, it is possible to compute the percentage loss that this payment implies for non-participating shareholders. 3/ In principle, this is computed by spreading the amount of the payment in excess of the target's market price equally over the remaining target shares outstanding.

3/ The exact equation for the percentage decline in stock price borne by non-participating shareholders is (D x F) (1-F), where D= percentage premium paid to block seller above pre-announcement market price, F= the fraction of the outstanding shares repurchased, (1-F) = the fraction of outstanding shares held by non-participating shareholders. For a 20% block repurchased at a 25% premium, this computation shows that the price of the remaining shares is expected to decline 6.67%, absent any "information effect" on stock price.

The second reason for the stock price decline is the "information effect." This refers to the reduced probability of a beneficial outcome caused by the announcement of the repurchase. Although expectations of a takeover or some other value-enhancing changes have already been diminished during the interim period, the repurchase announcement might dash any remaining hopes.

The information effect need not be negative, in theory. For example, the repurchase might provide good news by ending costly litigations, by ridding the target's managers of disruptive minority holders, or by reducing costly opposition to a valuable long-run corporate plan of the target's incumbent management. Finally, the repurchase might be a good investment if the market has undervalued the target's stock price sufficiently. Indeed, most stock repurchases via self-tender offers are motivated by a belief that the repurchase firm's stock price is too low. Moreover, the empirical evidence strongly supports this view; self-tenders at a premium typically cause substantial appreciation in the firm's stock price. (See Copeland and Weston (1981). It is plausible that targeted share repurchases are similarly motivated, as claimed publicly by the managers of many of these 89 targets that repurchase stock blocks.

4. Overall Change in Stock Price From Foothold Acquisition to Repurchase

The overall net-of-market return from before the foothold acquisition to after the repurchase agreement averaged over these 89 cases is negative 3.7%. The appreciation around the initial foothold acquisition is more than offset by the depreciation during the interim period and around public announcement of the repurchase. Figure 1 provides a visual depiction of the stock price pattern, based on the average net-of-market stock performance of these 89 cases. The stock price of the target after the repurchase, therefore, is below its level before the initial foothold acquisition. The overall decline is about one percent greater than what is implied by the average magnitude of the cost of the premium repurchase of the stock block. This implies that the "information effect" is negative, on average.

Splitting the sample into control contests and non-control contests yields some interesting results. The distinction for each of the 89 cases is made by researching the several press stories. Explicit mention of possible tender offers, proxy fights, or requests for board positions is the basis for classifying cases as control contests. Table 1 shows that there is little difference between the two sub-samples in their appreciation around the initial foothold acquisition (9.7 percent vs. 9.8 percent). Also, the interim period shows a quite similar negative net-of-market performance for each sub-sample. The depreciation around the announcement of the repurchase, however, is considerably greater for the control contests (-6.8 percent vs. -3.3 percent), so that the overall net-of-market return is significantly more negative for the control cases (-6.0 percent vs. -1.1 percent). Apparently, there is considerably more negative information accompanying the repurchase announcement for the control contest cases, although for both sub-samples the target firm's stock price is reduced overall, abstracting from general market movements.

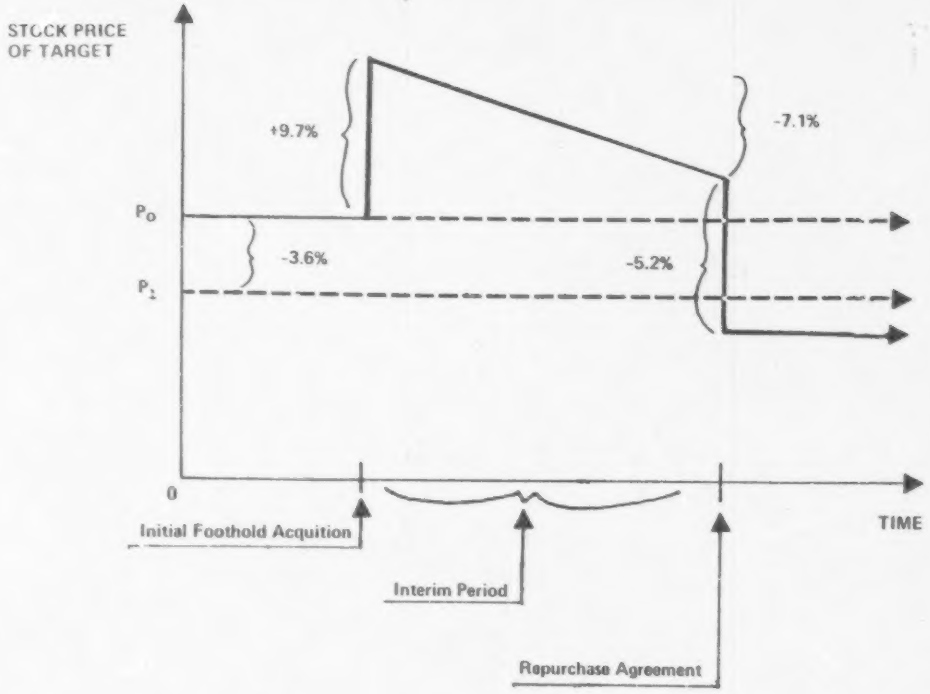
IV. The General Conclusions Drawn From This Evidence

Although these average results say little about any particular case, the evidence supports several general conclusions important to the public policy debate surrounding the practice of greenmail and the Commission's proposal to require its approval by shareholder vote. Let us turn first to the questions about the general motivation behind greenmail payments.

1. The Shareholder Welfare Theory

Targeted share repurchases could benefit the non-participating target shareholders under two general circumstances. The first circumstance involves the desirability of eliminating troublemaking minority shareholders sometimes dubbed "corporate raiders". Management groups targeted by corporate raiders often portray these raiders as troublemakers that mainly distract management from its daily work commitments, interfer with "correct" corporate policy, and create costly litigation. Paying off these raiders is beneficial to the other shareholders, if the dollar value of the total premium does not exceed the (discounted) future costs the raiders are expected to impose on the firm through their disruptive activities.

Figure 1



- Bold line shows typical stock price pattern
- P_o is (hypothetical) market price of target prevailing before initial foothold acquisition.
- P_1 is market price (P_o) minus the loss implied by the premium repurchase of the block.

The second circumstance under which greenmail might be beneficial to target shareholders is as a device by which management signals to the capital market that its share prices are undervalued. Numerous studies in the academic literature find that firm self-tender offers at a premium increase the value of the target shares. In many targeted repurchases, management claims similar benefits to non-participating shareholders. By this view the repurchase price is an attractive bargain, despite the premium, because the intrinsic value of the stock exceeds the repurchase price. Of course, self-tender offers allow all shareholders an equal opportunity to resell at a premium, in contrast to greenmail.

These two views are both rejected as general explanations of the motivations behind targeted share repurchases by this evidence. Both views imply that the announcement of the targeted share repurchase will cause an appreciation in the price of the target shares. In contrast to this prediction, the average reaction to this announcement over the 89 cases is a decline of 5.2 percent.

2. The Managerial Welfare Theory

The 9.7 percent appreciation that accompanies the initial foothold announcement reflects the significant benefits to non-participating shareholders that can come from the active participation of these block-holders. Many of the specific actions that lead to these benefits, however, impose significant costs on the incumbent management, in the form of foregone salary, perquisites, and prestige. The managerial welfare theory posits that targeted share repurchases are motivated primarily by incumbent management's desire to retain control of the target. The problem arises not from the mere retention of control, but from the losses imposed on shareholders from these actions that benefit incumbent management.

The possibility that a targeted share repurchase can mutually benefit the incumbent management and the block seller while harming the other shareholders arises because the benefits of changing control flow largely to the non-participating target shareholders. The dissent block-holder benefits through his share ownership by a third-party takeover at a premium. But, the great majority of the benefits go elsewhere, to other target shareholders principally. It becomes possible, therefore, for incumbent management to offer a relatively more lucrative payment to the dissident block-holder, even if the best interests of all shareholders are served by a change of control. If non-participating target shareholders have inadequate protections or remedies, then it is feasible for incumbent managements to offer mutually beneficial payments to block-holders to abandon their other plans which would largely benefit other shareholders.

The empirical evidence for the 89 cases examined here lends support to this general explanation of targeted share repurchases. While these motives may be absent in isolated cases, the overall evidence suggests that non-participating shareholders suffer significant overall losses from targeted share repurchases. In general, these transactions are not in the best interests of the non-participating target shareholders.

V. Conclusion

In the past year alone, over three and one-half billion dollars has been paid to the sellers of targeted share repurchases, representing cumulative premiums relative to market price of over 600 hundred million dollars. The Commission's tender offer reform proposals include a prohibition of such block repurchases not made to all shareholders, unless approved by a shareholder vote.

This proposal has generated some discussion among policy-makers. Several questions have arisen about the effects of these block repurchases on the stock prices of the target firms. This evidence is critical to determining the ultimate motivation of target managers in making these payments, which is important to judging the necessity of any legislative response to this practice.

This is a study of 89 cases of targeted share repurchases involving NYSE or ASE firms from 1979 to 1983. The focus is on measuring the wealth effects to non-participating shareholdes of these transactions. The results show that 1) the initial foothold acquisition by the block-holder induces an average 9.7 percent increase (net-of-market) in the target's stock price, 2) subsequent events including the announcement of the repurchase agreement cause stock price declines that more than offset this initial appreciation, and 3) the net overall stock price decline is roughly equal to the magnitude of the cash premium paid to the block seller. Also, the targeted share repurchase imposes larger wealth losses on non-participating shareholders when there is evidence that the foothold acquisition is associated with a contest for corporate control, such as a tender offer or a proxy contest.

This evidence of negative net effects of greenmail on stock prices supports the view that targeted share repurchases are counter to the best interests of the non-participating target shareholders. The costs imposed by this transaction are both the direct costs of the premium payment to the block seller and the indirect costs of foregone expected benefits from a change in corporate control. This evidence does not support the general view that the block-holders are destructive corporate raiders, or that the repurchases are valuable investments because the target's stock is undervalued.

It should be noted in closing that this evidence cannot rule out the possibility that other shareholders benefit indirectly by allowing targeted share repurchases. These "spillover" benefits could arise if the possibility of greenmail induces a sufficient amount of additional investments by corporate-control entrepreneurs in other targets, leading to takeovers and other valuable outcomes. Thus, even though by this evidence greenmail payments harm the non-participating shareholders of the repurchasing firm, the unmeasured spillover benefits might offset in some degree these measured losses to shareholders.

Finally, even if this evidence supports a firm conclusion that targeted share repurchases are counter-productive to society, it cannot provide any guidance about the best solution to this problem. The Commission's proposal has considerable merit. It focuses on the greenmail payment instead of erecting unjustified barriers to the initial formation of control-oriented stock blocks. It asks for shareholder approval, so that beneficial repurchases should not be unduly hampered. The evidence presented here on stock prices cannot, however, help to judge whether the Commission's remedy to greenmail is superior to the other possible remedies, such as relying on the courts to apply more stringent standards for managerial behavior in these cases.

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APPENDIX

Names of Repurchasing Firms and Sellers of Targeted
Share Repurchases, with 13D and Repurchase Dates,
for 89 Cases From 1979 to 1983.

	ISSUER	13D	REPURCHASE	SELLING SHAREHOLDER
1.	Zapata Corp	780113	790122	Crane Co.
2.	Chicago Pneumatic Tool	780605	790426	City Investing
3.	Shopwell	770823	790710	Jacques Amsellam
4.	Milton Roy	790614	790830	High Voltage Eng.
5.	West Pointe Pepperell	790726	790815	Gulf & Western
6.	Sherwin Williams	780619	791030	Gulf & Western
7.	Host International	791018	791105	General Host
8.	Buffalo Forge	790513	791205	H.K. Porter
9.	McNeil Corp.	790822	800201	Walco National
10.	Saxon Industries	791129	800204	Icann & Co.
11.	Penn Central Corp.	790508	800211	Reliance Finan.
12.	Anthony Industries	790514	800411	Justrite Mfg.
13.	Unitrode Corp.	790215	800731	Dynamics Corp. of Amer.
14.	Spencer Cos.	800213	800804	Inito Inc.
15.	Sta-Rite Inds.	800509	800804	Nortek Inc.
16.	Standard Coosa Thatcher	800520	800930	Walco National
17.	Robertshaw Ctl.	800922	801113	Gulf & Western
18.	Oxford Industries	800917	801121	Gulf & Western
19.	Dynamics Corp. of Am.	800114	801128	Southeastern Public Svc.
20.	Treadway Cos.	780717	801212	Care Corp.
21.	Pratt & Lambert	800529	810121	Silba Enterprises
22.	Kennecott	780314	810127	Curtiss Wright
23.	Gateway Industries	800118	810202	Agency Rent-a-Car
24.	Lane Bryant	800225	810213	Hatleigh Corp.
25.	Columbia Pictures	781120	810219	Kirk Kerkoran
26.	Chris-Chraft Ind.	801209	810317	Reliance Group
27.	Pat Fashions*	800214	810319	Tweedy Browne
28.	Bundy	800314	810407	Southeastern Public Svc.
29.	Collins & Aikman	801112	810428	Gulf & Western
30.	Diamond International	800620	810520	Simpson Paper
31.	Hastings Mfg.	791219	810527	Shufro, Rose, Ehrman
32.	Federal Paperboard	800115	810604	Reliance Corp.
33.	Hammermill Paper	800307	810701	Bayswavier Realty
34.	Leggett and Platt	810330	810710	Empire Inc.
35.	Cities Services	810522	810921	Nu-West Group
36.	L. E. Myers	810528	811116	Merrival Ltd.
37.	Greenman Bros.	801001	820121	Initio Inc.
38.	First Union Reit	790827	820222	Unicorp Financial
39.	Security Capital Corp.	810518	820408	Federated Reinsurance
40.	Fuqua Inds.	820106	820414	W.J. Kornyiak, et al.
41.	Morton Norwich	780224	820415	Phone-Poulenc S.A.
42.	Hartmarx	820303	820629	American Financial
44.	Kin Ark corp.	820427	820701	Hunderliter Energy
45.	Polaroid	811130	820816	Gulf & Western

46. Simplicity Patterns	811216	820817	Executive Life Ins.
47. U.S. Industries	820503	820831	First City Finan. of Vancouver
48. Harsco Corp.	810127	820910	Crane Co.
49. ACF Industries	820211	820914	Madison Fund
50. Del Labs	820226	821108	G. Lindeman
51. Ferro Corp.	810605	821108	Crane Co.
52. Todd Shipyards	820903	821115	Madison Fund
53. Amrep Corp.	811228	821124	Reliance Financial Svc.
54. Tosco Corp.	810521	821209	Kenneth Good, et al.
55. Norlin Corp.	801204	830308	LPH Panama S.A.
56. Management Assistance	810606	830328	Continental Telecom
57. Raymond International	830120	830425	Jacobs Engineering
58. Rexham Corp.	830613	830629	DWG Corp.
59. Holly Sugar	820305	830725	Jeffrey Picower
60. Berkey Photo	820628	830729	Nimsco Corp.
61. Louisiana Land & Explor.	791003	830819	Second Crescent Inv.
62. Superior Oil	830314	830901	Mesa Petroleum
63. Blue Bell	810202	831118	Bass Brothers
64. Gulf & Western	791210	831121	American Financial
65. Reece Corp.	800201	800430	Walco National
66. Standard Coosa Thatcher	791221	800630	Telepest Inc.
67. Bliss and Laughlin	790928	801212	Solar Sportsystems
68. Clarostat Mfg.	791113	820604	Dissident Shareholders
69. Freeport Minerals	780630	781026	Denison Mines
70. Aegis Corp.	800917	820122	Sol Goldman
71. Campbell Taggart	810604	811103	
72. Cluett Peabody	810325	811110	Gulf & Western
73. CTS Corp.	820312	820511	Belzberg Firms
74. Dillingham Corp.	810504	820506	Roslyn Park, et al.
75. EDO Corp.	780426	820503	Walter Kidde
76. Ennis Business Forty	790312	830225	Walter Kidde
77. Kerr Glass Mfg.	830427	830615	National City Lines
78. Lincoln National Corp.	770531	790713	American General Ins.
79. Masonite Corp.	810817	811215	First City Financial
80. MCO Holdings	821208	830222	Reliance Financial
81. Republic Airlines	800324	800507	Carl Icahn
82. Southeast Banking	820706	830920	Dissident Group
83. Stanwood	810405	830106	Initio Inc.
84. Chock Full O Nuts	811207	831102	J. Finkelstein, et al.
85. Turner Construction	810722	811230	
86. Zapata Corp.	790716	820129	David Murdock
87. Ponderosa Systems	800528	800613	General Host
88. Foremost McKesson	760205	810503	Sharon Steel
89. Anchor Hocking	820819	820323	Carl Icahn

A Study

by

The Office of the Chief Economist
Securities and Exchange Commission
450 5th Street, NW.
Washington, DC 20549

April 19, 1985

Institutional Ownership, Tender Offers, and Long-Term Investments

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The views expressed herein are those of the Office of the Chief Economist only. The Commission has expressed no view on this study.

Institutional Ownership, Tender Offers, and Long-Term Investments

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One of the principal arguments made by critics of hostile tender offers is that the threat of a hostile tender offer preoccupies corporate executives with propping up short-term earnings, at the expense of investing in long-term projects, such as research and development. 1/ Although this argument, hereafter referred to as the "short-term argument", has attracted a sympathetic audience, no evidence has yet been advanced in its support. This study empirically examines the argument and concludes that it is not supported by statistical evidence presented here.

The Short-Term Argument

Central to the short-term argument is the observation that institutional investors (e.g., pension funds, mutual funds) have come to dominate the ownership of corporate equity. In contrast to the traditional individual shareholder, it is argued that institutional investors have short-time horizons, and regularly "churn" their portfolios. This proclivity to churn supposedly derives from two sources: the fiduciary responsibility of fund managers, and the intensely competitive market for money managers that results in quarter-to-quarter monitoring of their performance.

This behavior of large institutional shareholders purportedly facilitates hostile tender offers - institutional investors stand ready to tender their shares to any bidder offering even a small premium over market price. To stave off hostile takeover attempts, corporate managers supposedly try to prop up stock prices by increasing short-term earnings, even at the expense of abandoning otherwise profitable long-term investment projects in which present expenditures are incurred in anticipation of future earnings. According to proponents of the short-term argument, this induced myopia is ubiquitous among corporate executives and it is eroding our country's ability to compete in the international economy. 2/

On conceptual grounds, many economists are critical of the short-term argument. 3/ Implicit in the short-term argument is the view that the capital market systematically undervalues expected earnings. The argument assumes that investors are persistently fooled by firms that reduce expenditures on economically viable long-term investment projects in order to inflate present earnings. Economists argue that the arbitrage possibilities presented by systematic mispricing of securities creates strong financial incentives for self-correction in the stock market. This occurs as sophisticated investors bid up (down) the price of undervalued (overvalued) securities until the price of a security equals an unbiased estimate of its "true" value. The economists' view does not deny that under some circumstances, corporate managers may have incentives to artifically inflate earnings in ways that are costly for investors to monitor. Inflating short-term earnings by reducing expenditures on otherwise profitable investment projects, however, is too visible, particularly to sophisticated investors such as institutional funds. Firms that followed this practice, according to these economists, would unfavorably affect their stock price, thereby rendering this strategy ineffective in staving off hostile tender offers.

Although economists have not directly examined the relationship between institutional ownership, hostile tender offers, and investment in long-term projects, there is an abundance of indirect evidence that is inconsistent with the short-term argument. There is, for example, considerable stock price evidence showing that the market effectively values time-discounted cash flows, not simply current reported earnings. For example, the market does not devalue companies that switch their inventory valuation from first-in, first-out (FIFO) to last-in, first-out (LIFO), even though this accounting change is supposed to reduce reported earnings during periods of positive inflation rates. 4/ Also, the fact that price-earnings ratios vary widely across firms indicates that the market does discriminate in assessing the future prospects of firms. 5/ In addition, received wisdom holds that the principal sources of financing for venture capital firms are institutional investors, which seems to damage the argument that institutional investors are attracted only to firms with relatively high short-term earnings.

Testable Implications of the Short-Term Argument

Besides this abundance of indirect evidence, which is inconsistent with the short-term argument, no evidence that directly addresses the short-term argument has yet been presented by either its proponents or its critics. 6/ Given the profound implications of accepting this argument, it is important that it be subjected to rigorous empirical testing. In our view, the short-term argument has the following testable implications:

- An inverse relationship should exist between the percentage of a firm's equity held by institutional investors and the level of the firm's investment in long-term projects, such as R&D (i.e., the greater the institutional holdings, the lower is R&D).
- Target firms in tender offers should exhibit high spending on long-term investment projects relative to their past experience, and relative to other firms in the same industry
- The percentage of equity held by institutional investors in target firms of tender offers should be higher than the corresponding figure for non-target firms in the same industry, preceding their takeover.
- The public announcement by firms that they are embarking on a new long-term investment project should result in a negative stock price reaction, reflecting the market's expectation that short-term earnings will be adversely affected.

The remainder of this study reports the results from an empirical investigation of these and related implications of the short-term argument.

Empirical Results

Institutional Holdings and Investments in R&D

The short-term argument makes a testable prediction about the relationship between the percentage of a firm's equity held by institutions and its investment in long-term projects. Since this argument states that the growth of institutional ownership is inducing myopia among corporate executives, we should observe relatively low (high) investment in long-term projects by companies having a large (small) percentage of equity held by institutions.

To examine the relationship between institutional ownership of corporate equity and investment in long-term projects, we collected data for 324 firms representing a cross section of industries including aerospace, appliances, automobiles, chemicals, drugs, electrical, fuel, information processing, instruments, leisure, farm machinery, paper, personal and home care products, semiconductors, steel, telecommunications, food and beverages, and tires and rubber. This sample consists of all firms in these industries which were listed in the Business Week "R&D Scoreboard" for each of the years, and for which we were able to obtain data on institutional ownership. For each of these firms we collected the following data for each of years 1980-1983: the percentage of common equity held by institutions that report to the SEC under Rule 13F (i.e., institutional funds with combined equity assets in excess of $100 million), total revenues, net income before extraordinary items or discontinued operations, and company sponsored R&D expenditures, which is our proxy for the companies' investment in long-term projects. The firms vary widely in size, ranging from Gelman Sciences with 1983 revenues of $40 million to Exxon with 1983 revenues of $89 billion.

In short, these data tend to refute the short-term argument. Table 1 shows that institutional ownership, as a percentage of common equity, has steadily increased from an average of 30.0 in 1980 to 38.0 in 1983. Concomitant with this increase has been a steady increase in the average ratio of R&D to revenues, from 3.38% in 1980 to 4.03% in 1983. In the aggregate, then, institutional ownership has been increasing, but there is no evidence that corporate managers have become increasingly myopic by investing more in short-term projects. Indeed, the opposite is true, according to these data.

Since the level of a firm's R&D expenditures is determined by many factors, it is useful to probe behind the aggregate data to detect the incremental impact of institutional ownership on R&D expenditures. Table 2 contains results from estimation of a regression equation in which the average R&D to revenues ratio (1980-1983) for each of the firms is regressed on: i) the average percentage of equity held by institutional investors in the firm over the same period, and ii) a series of industry dummy variables. These results reveal, holding industry effects constant, that there is a direct and statistically significant relationship between institutional ownership and R&D expenditures. This means that the higher the institutional holdings in a firm, the higher is its R&D activity. Although these results do not establish that higher institutional ownership causes high R&D expenditures, they do strongly suggest that institutional investors are not deterred from investing in firms with high R&D expenditures.

The causal relationship between institutional ownership and R&D expenditures can be investigated empirically by examining what happens to R&D expenditures in firms that experience changes in the percentage of its equity held by institutional investors. In many of the 324 firms in our sample, there were sizeable changes in the percentage of equity held by institutions, ranging from a decline of 29 percentage points in Mattel to an increase of 48 percentage points in Outboard Marine. The short-term argument predicts that companies such as Outboard Marine will become more vulnerable to hostile takeovers. As a result, these companies will become increasingly more preoccupied with short-term earnings, which should manifest itself in reductions in R&D expenditures. By the same logic, companies experiencing substantial reductions in institutional ownership will feel less threatened by a hostile takeover, which should result in an increase in their R&D expenditures.

Tables 3 and 4 list results which contradict the prediction of the short-term argument. In Table 3, we list the average changes in the ratio of R&D outlays to sales from 1980 to 1983 for firms that experienced a decline in institutional ownership and for groups of firms that experienced progressively larger increases in institutional ownership. The average change in R&D-sales ratio for the firms experiencing a decline in institutional ownership was 0.67%. The corresponding change for firms experiencing an increase in institutional ownership was almost identical, 0.65%. Furthermore, no discernible pattern in R&D changes exists among firms with increasingly larger positive changes in institutional holdings.

Table 4 contains regression results from an equation in which the change in R&D-revenue ratio for each of the 324 firms is regressed on the change in institutional holdings and a set of industry dummy variables. These results indicate that a positive, but statistically insignificant relationship exists between changes in institutional holdings and changes in R&D expenditures. In short, Tables 3 and 4 do not provide empirical support for the argument that an increase in institutional ownership causes corporate managers to become myopic.

R&D Activity and Institutional Ownership in Target Firms of Tender Offers

Another testable proposition of the short-term argument is the contention that firms which invest in long-term projects will suffer declines in the market value of their equity, and possibly a takeover. This proposition implies that R&D expenditures in target firms of tender offers should be high relative to the firm's past experience and relative to an industry control group of nontarget firms.

To test this proposition, we consulted the pre-tender offer, 10-K reports of all target firms in successful tender offers during the period 1981-1984. Of the 217 target firms in this sample, 160 firms reported that their R&D expenditures were "not material". This high percentage of actual targets not reporting material R&D outlays ssuggests that it is incorrect to identify actual targets with intensive R&D activity. For the remaining 57 firms in the sample having material R&D outlays, we calculated the R&D-to-revenue ratio in the year immediately preceding the tender offer, and in the three prior years. For the same years, we also calculated these ratios for the industries in which these firms competed.

Table 5 shows that, contrary to the short-term argument, the value weighted R&D-revenue ratio for target firms, 0.77%, was less than one-half that of the industry control groups, 1.66%, in the year immediately preceding the tender offer. Furthermore, these data were not significantly different from the corresponding data in the three previous years: 0.75% for target firms and 1.49% for the industry control groups. These data strongly suggest that investment in long-term projects such as R&D does not make a firm vulnerable to takeovers.

We caution, however, against drawing the tempting inference that target firms typically "underinvest" in R&D. As Table 6 shows, these target firms were significantly smaller than their industry counterparts. Median revenue for the 57 target firms in the year immediately preceding the tender offer was $312 million, as compared with a corresponding median of $1382.6 million for the industry control groups. Similarly, the average revenue for the two sets of firms was $1731.5 million and $2592.1 million, respectively. To the extent that economies of scale exist in R&D, which is a common and sensible belief, it is natural to expect smaller firms to have smaller R&D-revenue ratios than larger firms. Nonetheless, the data do not support the proposition that target firms tend to "overinvest" in R&D projects.

The short-term argument also predicts that institutional ownership in target firms is higher than institutional ownership in nontarget firms. Table 7 lists the average percentage of equity held by institutional investors (that report to the SEC under 13F) in 177 target firms (1981-1984) in the quarter immediately preceding the tender offer. Also listed is the corresponding average for 177 industry control groups. The data show that institutional ownership in the target firms, 19.3%, was actually lower, than it was, 33.7%, in the industry control groups. Given that target firms typically are smaller than their industry counterparts, this difference may be attributed to size differences. These data do, however, suggest that it is not high institutional ownership *per se* that fuels tender offers.

Stock Price Reaction to R&D Announcements

Finally, the short-term argument unambiguously predicts that the stock market devalues firms which invest in projects that impair their short-term earnings, even if these projects have a positive net present value. To test this prediction, we examined the stock price reaction to 62 Wall Street Journal announcements that firms were embarking on an R&D project. These announcements were collected by instructing NEXIS, the news retrieval system, to provide us with all Wall Street Journal articles containing the words "research and developent" during the period 1973-1983. Using the conventional event study methodology, 7/ we estimated the net-of-market stock returns to shareholders of the 62 firms around the date on which they announced their R&D projects.

Table 8 contains the results from this experiment. On the announcement day, Day 0, these firms experienced an average abnormal return of positive 0.45%, followed by an additional 0.35% abnormal return on the next trading day. The two-day announcement return of 0.80% is statistically significant (t-statistic = 2.5) and represents a substantial net-of-market increase in the value of the firm's equity. During the 20 trading days after the announcement, the cumulative net-of-market return increases to 1.8%.

This evidence strongly refutes the proposition that the stock market values only short-term earnings, and not expected future earnings. A logical inference to be drawn from this evidence is that it is futile for corporate managers to try to forestall a hostile takeover by pumping up short-term earnings at the expense of investing in long-term projects with positive net present values.

Conclusion

The evidence reported in this study uniformly contradicts the short-term argument. This evidence shows:

- For a sample of 324 firms in a diverse set of industries, the percentage of equity held by institutional investors (that report to the SEC under Rule 13f) increased from 30% in 1980 to 38% in 1983. During this same period, the average R&D-revenue ratio for these firms also increased from 3.38% to 4.03%. These aggregate data do not support the argument that the growth in institutional ownership of corporate equity is forcing corporate managers to become more myopic. (See Table 1.)

- Regression analysis reveals that, holding industry effects constant, institutional investors actually seem to favor firms with high R&D-revenue ratios. (See Table 2.)

- In our sample of 324 firms, 88 firms experienced a decline in institutional ownership during this period and 236 firms experienced an increase in institutional ownership. The average change in R&D-revenue ratio for the two groups of firms, however, was almost identical - 0.67% for the former group and 0.65% for the latter group. These data refute the argument that increases in institutional ownership cause managers to focus more on the short-term. (See Table 3.)

- Regression analysis reveals that, holding industry effects constant, changes in institutional holdings are not correlated with changes in R&D activity. (See Table 4.)

- Examination of data on R&D expenditures for 57 target firms (1981-1984) reveals that these firms had an average R&D-sales ratio, 0.77%, which was less than one-half of that, 1.66%, for an industry control group in the year immediately preceding the tender offer. These data strongly suggest that investment in long-term projects does not increase a firm's vulnerability to a takeover. It is also noteworthy that an additional 160 target firms during this period reported (in their 10-K's) that their R&D expenditures were "not material". We caution against drawing the inference that these firms became vulnerable to a takeover because they were underinvesting in R&D activity. Target firms are smaller than their industry counterparts, and to the extent there are economies of scale in R&D, it is natural to find lower R&D-sales ratios for target firms. (See Table 6.) In addition, the target firms' R&D-revenue ratio in the year immediately preceding the tender offer is not significantly different from the corresponding ratio, 0.75%, in the previous three years.

- The average percentage of equity held by institutional investors in 177 target firms (1981-1984) for which we were able to obtain ownership data was 19.3% in the quarter immediately preceding the tender offer, as compared with a corresponding average of 33.7% for firms in an industry control group of nontarget firms. These data seem to contradict the assertion that heavy institutional ownership *per se* gives rise to hostile takeovers. (See Table 7.)
- Stock price evidence reveals that the capital market positively values companies that announce that they are embarking on an R&D project. The net-of-market increase in the equity value of 62 firms making such announcements (1973-1983) was 0.80% over the two days following the announcement, and this increase is statistically significant. This evidence rebukes the argument that the market penalizes companies that invest in long term projects and thereby makes them candidates for - hostile takeovers.

Collectively, this evidence seems to refute the short-term argument. We welcome comments and suggestions for improving the study from both proponents and critics of this argument.

FOOTNOTES

1/ This argument has appeared frequently in the business press, including "Andrew Sigler: Rules for the Takeover Game", Financier (March 1985), pp. 15-20; Peter Drucker, "Taming the Corporate Takeover", Wall Street Journal (October 30, 1984); Allan Sloan, "Why is No One Safe?", Forbes (March 11, 1985), pp. 134-140; "Will Money Managers Wreck the Economy?", Business Week (August 13, 1984), pp. 86-91. This argument also has surfaced in Congressional proposals to regulate hostile takeovers. See, for example, Martin Lipton's proposal, "The Shareholder Protection and Elimination of Takeover Abuses Act of 1985", November 20, 1984.

2/ Proponents of the short-term argument frequently contend that takeover fear is eroding our competitive position vis-a-vis Japan. Interestingly, however, the percentage of equity owned by institutional investors in Japan has increased significantly during the past 32 years from 38.6% in 1980 to 71.9% in 1982. (Source: Securities Markets in Japan 1984 (Tokyo: Japanese Securities Research Institute), 1983) One scholar even attributes the farsightedness of corporate management in purported Japan to the dominant ownership position of institutional investors: "In Japan, where virtually all equity is held by banks and large investment firms, the concern for short-term performance is not nearly as acute for longer-term prospects. As a result, Japanese firms are not as concerned as Western firms about short-term profits or, for that matter, profits in general." (See C. Carl Pegels, Japan vs. the West (Kluwer-Nijhoff), 1984.)

3/ See, for example, the testimony of Professors Harold Demsetz, Michael Bradley, and Michael Jensen in the transcript for the SEC Economic Forum on Tender Offers, February 20, 1984.

4/ See, for example, Shyam Sunder, "Stock Price and Risk Related to Accounting Changes in Inventory Valuation", Journal of Accounting Research (April 1975), pp. 305-313.

5/ These points were made by the economists at the SEC Economic Forum on Tender Offers, February 20, 1985. See footnote 3.

6/ Preliminary findings from this empirical inquiry were sent to SEC Chairman John S.R. Shad in two memos, dated January 22, 1985 and February 20, 1985.

7/ For a discussion of this methodology, see William Schwert, "Using Financial Data to Measure Effects of Regulation", Journal of Law and Economics (April 1981), pp. 121-158.

TABLE 1

Average Institutional Holdings (As Percent of Common Equity) and Average R&D/Revenue for 323 Corporations, 1980-1983

	Average Institutional Holdings	Average R&D Expenditures As Percentage of Revenue
1980	30.0	3.38%
1981	31.2	3.58
1982	34.3	3.98
1983	38.0	4.03

TABLE 2

OLS Estimate of Average R&D/Revenue, 1980-1983, as Function of Average Institutional Holdings, and Industry Variables (t-statistics in parentheses)

Intercept	0.03
	(6.6)
Institutional Holdings	0.0002
	(2.9)
Chemicals	-0.01
	(2.4)
Drugs	0.04
	(5.7)
Aerospace	-0.005
	(0.7)
Appliances	-0.02
	(2.2)
Automobiles	-0.005
	(0.4)
Leisure	-0.009
	(1.1)
Fuel	-0.04
	(4.4)
Paper	-0.03
	(4.0)
Steel	-0.03
	(2.3)
Electrical	-0.03
	(3.9)
Home Care	-0.02
	(2.3)
Tires and Rubber	-0.03
	(2.7)
Instruments	0.003
	(0.7)
Hi Tech*	0.02
	(4.5)
Food	-0.02
	(3.9)
N	324
R^2	0.41
F	13.1

*HiTech includes information processing, office equipment, semiconductors and telecommunications.

TABLE 3

Average Change in Institutional Holdings (as Percent of Common Equity), 1980-1983 and Average Change in R&D/Revenue, 1980-1983 for Firms with Negative and Increasingly Positive Changes in Institutional Holdings

Group of Firms	Average Change in Institutional Holdings 1980-1983	Average in R&D as Percentage of Revenue, 1980-1983
88 Firms with a Decline in Institutional Holdings	-5.53	0.67%
236 Firms with Increase in Institutional Holdings	13.02	0.65
79 Firms with Smallest Increase in Institutional Holdings	3.84	0.89
77 Firms with Median Increase in Institutional Holdings	10.67	0.41
80 Firms with Largest Increase in Institutional Holdings	24.33	0.64

TABLE 4

OLS Estimate of Change in R&D/Revenue, 1980-1983 as Function of Change in Institutional Holdings, 1980-1983 and Industry Variables (t-statistics in parentheses)

Intercept	0.006
	(2.3)
Change in Institutional Holdings	0.00005
	(0.6)
Chemicals	-0.0008
	(0.2)
Drugs	0.01
	(2.9)
Aerospace	-0.0002
	(0.0)
Appliances	-0.005
	(0.8)
Automobiles	-0.01
	(1.6)
Leisure	0.001
	(0.2)
Fuel	-0.005
	(0.9)
Paper	-0.005
	(1.0)
Steel	-0.003
	(0.4)
Electrical	-0.002
	(0.5)
Homecare	-0.004
	(0.9)
Tires and Rubber	-0.0008
	(0.1)
Instruments	0.0005
	(0.3)
HiTech*	0.003
	(1.1)
Food	-0.002
	(0.5)
N	324
R^2	0.07
F	1.4

*Hi Tech includes information processing, office equipment, semiconductors, and telecommunications.

TABLE 5

R&D as Percentage of Revenue for 57 Target Firms and their Industry Groups in Year Prior to Tender Offer and the Three Previous Years

Group of Firms	R&D as Percentage of Revenue in Year Preceding Tender Offer	R&D as Percentage of Revenue During Previous Three Years
Target Firms	0.77%	0.75%
Industry Group	1.66	1.49

TABLE 6

Median Revenue and Average Revenue in Year Prior to Tender Offer for 57 Target Firms and Their Industry Groups

Group of Firms	Median Revenue in Year Preceding Tender Offer (in millions)	Average Revenue in Year Preceding Tender Offer (in millions)
Target Firms	$ 312.0	$1731.5
Industry Group	1382.6	2592.1

TABLE 7

Percentage of Equity Held by 13f Institutions in 177 Target Firms of Tender Offers and Their Industry in Quarter Prior to Tender Offer

Group of Firms	Average Percentage of Equity Held by 13f Institutions
Target Firms	19.3%
Industry Group	33.7

TABLE 8

Abnormal Returns of NYSE and Amex Listed Companies that Announced Research and Development Budget/Centers During January 1, 1973 through December 31, 1983. Event Day 0 is the announcement day.

Event Day	Daily Abnormal Return	Cumulative Daily Abnormal Return	Percent Negative	Number of Firms
-20	0.10	0.10	50.0	62
-19	-0.27	-0.17	64.5	62
-18	[illegible]	-0.03	51.6	62
-17	[illegible]	-0.25	50.0	62
-16	-0.18	-0.43	45.2	62
-15	0.12	-0.32	56.5	62
-14	0.03	-0.29	53.2	62
-13	-0.08	-0.37	58.1	62
-12	0.33	-0.04	53.2	62
-11	-0.70	-0.74	61.3	62
-10	-0.24	-0.98	62.9	62
-9	0.03	-0.95	48.4	62
-8	-0.50	-1.45	59.7	62
-7	0.11	-1.35	51.6	62
-6	0.07	-1.27	51.6	62
-5	-0.18	-1.45	59.7	62
-4	0.37	-1.08	37.1	62
-3	0.37	-0.71	43.5	62
-2	-0.10	-0.81	61.3	62
-1	-0.29	-1.10	58.1	62
0	0.45	-0.65	37.1	62
1	0.35	-0.30	46.8	62
2	0.31	0.02	46.8	62
3	-0.01	0.01	45.2	62
4	0.09	0.10	45.2	62
5	0.36	0.46	50.0	62
6	-0.15	0.31	48.4	62
7	0.29	0.60	43.5	62
8	0.12	0.72	50.0	62
9	0.26	0.97	54.8	62
10	0.29	1.26	41.9	62
11	0.38	1.65	45.2	62
12	0.14	1.79	51.6	62
13	0.16	1.95	50.0	62
14	-0.02	1.93	50.0	62
15	0.26	2.19	48.4	62
16	0.15	2.34	46.8	62
17	-0.27	2.07	51.6	62
18	-0.31	1.76	58.1	62
19	0.09	1.86	53.2	62
20	-0.05	1.80	51.6	62

A Study

by

The Office of the Chief Economist
Securities and Exchange Commission
450 5th Street, NW.
Washington, DC 20549

April 19, 1985

The Economics of Any-or-All, Partial, and Two-Tier Tender Offers

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The views expressed herein are those of the Office of the Chief Economist only. The Commission has expressed no view on this study.

The Economics of Any-or-All, Partial, and Two-Tier Tender Offers

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In Release No. 34-21079 the Commission requested public comment on certain recommendations proposed to the Commission by its Advisory Committee on Tender Offers. That release incorporated a study by the Office of the Chief Economist (OCE) of successful tender offers in calendar years 1981-1983. This memorandum is an updated and revised study of tender offers in calendar years 1981-1984. In addition to updating the original study through 1984, this improved study expands upon the initial study by including data on the frequency and effect of negotiated versus non-negotiated tender offers. This study also examines the fraction of shares tendered into two-tier, partial and any-or-all tender offers.

The theory, discussion, and results of this revised study are broadly consistent with those of the initial OCE study. Notably, the relative frequency of two-tier tender offers has continued to decline in 1984 while the frequency of negotiated tender offers has continued to increase to more than two-thirds of all offers made in 1984.

This memorandum is organized into several sections. The first section is a brief overview of the criticism of partial and two-tier offers. The second section describes our data and empirical methodology. The third section considers some theoretical explanations of partial and two-tier tender offers. The fourth section relates our empirical information to the controversy. Section five reviews multiple bidder contests. A summary and conclusion ends the paper.

Our study reveals these characteristics of any-or-all, two-tier and partial tender offers initiated between January 1981 and December 1984.

- Any-or-all offers are more frequent than partial and two-tier offers (159 as opposed to 69). Two-tier tender offers are now quite infrequent, comprising just 7 of 82 offers in 1984. (See Table 1a.) The incidence of any-or-all offers is higher among smaller targets while two-tier offers predominate among medium-size and large targets. (See Table 2.)
- More than half of all tender offers are negotiated. Two-thirds (100 of 148) of the contests that begin as any-or-all offers are negotiated with target management from the start. Half (21 of 40) of the contests initiated by two-tier offers are negotiated from the start. However, relatively few (7 of 40) initial partial offers are negotiated. (See Tables 1b and 1c.)

- More than three-quarters of all tender offers are ultimately negotiated. Most (133 of 159) of the contests that culminate in any-or-all offers are ultimately negotiated with target management. Virtually all (35 of 38) successful two-tier offers are negotiated. Partial offers are less frequently negotiated (12 of 31). (See Tables 1b and 1c.)
- Any-or-all premiums and two-tier blended premiums are very similar in magnitude -- 71 percent of two-tier premiums exceed 40 percent while 70 percent of any-or-all premiums do so. (See Table 5.) The average premium for any-or-all offers is 59.6 percent compared to an average blended premium in two-tier offers of 54.5 percent.
- The first-tier of a two-tier offer at 62.8 percent is very similar to the average bid premium of an any-or-all offer at 59.6 percent. However, the average bid premium of partial offers is lower at 34.4 percent. (See Table 6.)
- Over two-thirds of the 38 two-tier offers have less than a 20 percent difference between the two-tiers. In contrast, less than half of the 30 partial offers have less than a 20 percent difference between the two tiers. (See Table 8.)
- A higher proportion of outstanding shares are tendered on average into any-or-all offers (73

percent) than into two-tier offers (62 percent) or pure-partial offers (34 percent). (See Table 9.)

I. The Controversy Behind Partial and Two-Tier Tender Offers

In Release No. 34-21079, the Commission describes the concerns surrounding partial and two-tier offers. Central to these concerns is that target shareholders may be induced to tender to a partial or two-tier offer when an alternative any-or-all offer may have a higher overall premium. A two-tier offer might be accepted over an any-or-all offer in this case because shareholders tender to a high first tier to avoid a relatively low second tier. Though shareholders would be better off on an overall basis if they tendered to the any-or-all offer rather than tendering to the two-tier offer, shareholders are not certain which offer will be accepted. A situation is created where shareholders may tender to the first tier of the two-tier bid because of fear of being forced to accept a lower second-tier offer if the bidder obtains control in the two-tier offer. Commentators suggest that this process is coercive and encourages shareholders to tender when the overall two-tier premium is not as attractive as existing or potential any-or-all offers.

Our research focuses on identifying partial and two-tier offers and computing offer or first-tier premiums and "blended" premiums (which combine first-tier and second-tier premiums). These premiums are compared for evidence of shareholders accepting relatively low overall bids in partial or two-tier offers for indications of coercive behavior. In addition, the frequency of such offers and the role of target firm management in negotiating these offers are studied. It is hoped that the evidence presented will provide a springboard for further discussion and research.

II. Data and Methodology

This study is based on 14D filings with the SEC by bidding firms and target firms. From these, we take all "successful" cash offers (defined as those in which any target shares at all were purchased) executed between January 1981 and December 1984. For these offers, we compile a data base detailing offer terms, pre- and post-offer prices of target shares, and other information such as total number of target shares and number of shares previously held and sought by the bidder. 1/

1/ In a few cases it was necessary to eliminate a tender offer from our sample due to lack of contemporaneous price information about the target firm. Tender offers were also excluded if they were clean-up offers after the bidder had already obtained control of the firm. A list of excluded offers is available upon request.

Transactions involving an exchange of shares, as opposed to tender offers, are specifically excluded from our sample. For example, in the complicated Martin Marietta/ Bendix case, we include only the various tender offers in which shares were purchased. These offers include Martin Marietta's offer for Bendix and Bendix's offer for Martin Marietta. United Technologies friendly tender offer for Martin Marietta is not included because no shares were purchased under it and Allied's merger with Bendix is also excluded since no tender offer was involved.

Data is also extracted from 14D filings on the nature of any written agreements between bidder and target managements. A negotiated offer is defined as one made pursuant to a written agreement with target management. Included are formal merger agreements, stock option agreements that give the bidder the right to purchase the target's authorized but unissued shares, or stock purchase agreements that give the bidder the right to purchase the shares held by target managers and other large holders (if not tendered). These written agreements always call for target management to also recommend the offer to their shareholders. The general effect of these agreements is to give the preferred bidder an advantage over competing bidders. Since the initial bid of a takeover contest is less likely to be negotiated than the ultimately successful bid, results are reported for whether or not the initial bid of a contest is negotiated and for whether or not the successful bid is negotiated. An initial bid may be superceded by a bid from a different bidder or by a revised bid from the same bidder.

In general, tender offers may be divided into two basic groups depending on whether prorationing is a factor in the bid. An any-or-all offer states that the bidder will buy any tendered shares of the target firm. Typically, the offer is conditional on a minimum number of tendered shares sufficient to insure control after the offer. In an any-or-all offer, target shareholders knows that all of their tendered shares will be purchased at the offered premium as long as the minimum conditions are met.

If the bidder seeks less than all target shares, he bears the risk that too many shares will be tendered. Consequently, the second type of tender offer is one in which the bidder states a maximum number of shares to be purchased in addition to a minimum. If the offer is oversubscribed, the tendered shares will be subject to prorationing. When the offer is executed under prorationing, each tendering account has the same fraction accepted. Prorationing requirements ensure that each target shareholder receives a proportionate share of the terms of the tender offer.

This second type of offer may be divided into several subgroups. A pure partial offer we define as one in which there is no announced second-tier offer during the tender offer and no clean-up merger or tender offer closely following the execution of the tender offer. If the partial offer is for control of the target firm and is successful, a minority interest is left trading the target firm's shares in the market. More commonly, partial offers are for less than 50 percent. In any case, the trading price of the unpurchased target shares is the "second tier" of a partial offer.

A two-tier offer combines a partial tender offer for control with a subsequent merger. In a negotiated two-tier offer, the bidder, at the time of the first-tier offer, agrees with target management on the terms of the subsequent merger. The first tier is for a controlling interest in the target firm and almost always offers cash for the target shares. The second tier is likely to involve an exchange of securities for the remaining shares. The first-tier price is offered to shareholders on a prorata basis and the value of the second-tier is usually less than the first-tier offer on a per-share basis.

A non-negotiated two-tier offer lies between the pure partial offer and the negotiated two-tier offer. although no second-tier merger terms are agreed to at the time of the original offer for control, the bidder announces an intention to cause a merger. The second-tier price in non-negotiated two-tier offers is again generally lower than the first-tier price and it usually offers securities for the target shares.

Central to our research is the calculation of percentage premiums paid in tender offers over and above previous market values. As a measure of the effect of tender offers on target shareholder wealth, we compute a "blended" price that reflects the overall price paid to all outstanding shares. The price paid to each "tier" is weighted by the fraction of shares receiving that price. We express a blended price as:

$$P_B = (F \times P_T) + ((1-F) \times P_E),$$

and a blended percentage premium as $((P_B/P_O)-1) \times 100$.

where: P_B = the blended price of the offer,

P_T = the per-share, first-tier offer price,

P_E = post-offer market price of target shares, F = the fraction of shares purchased in the first tier of the offer,

P_O= pre-contest market price of target shares.

The data required for this formula are readily available. The tender offer price (P_T) is simply the cash bid of the tender offer. The pre-contest market price of the target shares (P_O) is measured 20 trading days before the announcement of the initial offer of a contest, even where the initial offer is unsuccessful and even where the initiating offer is a merger offer. This earlier price is used to lower the probability that leakage of information about an impending tender offer has raised P_O above its value in the case of no tender offer.

We estimate the second tier or clean-up price (P_E) in each type of offer as the market price of target shares 20 trading days after the expiration of the offer. In pure partial offers and non-negotiated two-tier offers, the face value of the second-tier is unspecified in the offer. Even in negotiated two-tier offers, where the second-tier terms are set, the actual value of the security used may not equal its face value or the value claimed by the bidder. Consequently, when the second tier consideration is other than cash, we use the market value of the securities, not the value as stated by the bidder. In those any-or-all offers where very few public shares remain after the offer, we use the stated terms of the second step cash merger.

In an any-or-all offer, the blended premium is essentially equal to the offer premium in the first tier. This is because a high proportion of shares are typically tendered into an any-or-all offer, and because the second tier typically is a cash merger at the same price as the offer. However, when an any-or-all offer is undersubscribed, with no subsequent merger, the calculation of the blended premium will reflect that shareholders are opting for the (typically higher) second-tier market value.

III. Why Bidders Use Partial and Two-Tier Tender Offers

The formula for the blended premium can be used to show that any partial offer has a matching any-or-all offer in which target shareholders receive the algebraically equivalent premium. For example, a two-tier offer of $20 for 50 percent of the outstanding shares and securities worth $10 for the other 50 percent is algebraically equivalent to a uniform offer of $15 for any-or-all shares outstanding. The premium of the any-or-all offer equals the blended premium of the two-tier bid. Total outlay to the acquiring firm is equal under these bids assuming both induce 100 percent tenders. What are the economic differences, then, between partial and two-tier offers and any-or-all offers, and why are partial or two-tier tender offers preferred by some bidders? Several explanations have been suggested:

1. A partial tender offer leaves outstanding a substantial equity interest in the target firm with the value of the

outstanding shares determined in a competitive exchange market. In its report, the SEC Advisory Committee on Tender Offers cites several benefits of partial offers in addition to those listed below. 2/

A related point is that a partial tender offer is conditional in that it obligates the bidder to purchase only up to a pre-set maximum number of shares regardless of how many shares are tendered. The partial offer therefore sets an upper bound on the total cash outlay required for the bidder to obtain the desired fractional interest in the target. This allows the bidder to eliminate the uncertainty that exists with any-or-all offers about how many shares will be tendered in response to a pre-set premium.

2. A two-tier tender offer can increase the incentive for target shareholders to tender by offering a high first-tier premium and a relatively low second-tier premium. The greater the difference between the first-tier premium and the second-tier premium, the greater is the opportunity cost to target shareholders of not tendering if the offer succeeds. Under certain conditions, target shareholders can be induced to tender into a two-tier offer even though its blended premium is less than the uniform premium of an alternative any-or-all offer that is forthcoming. As identified by Professor Bradley,

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2/ SEC Advisory Committee on Tender Offers, Report of Recommendations, July 8, 1983, pp. 24-25.

this situation is analogous to the classic prisoner's dilemma. 3/

The prisoner's dilemma analysis as applied to two-tier tender offers is clearer with an example. Suppose a target firm with 1,000 outstanding shares has a market value of $10 per share before the tender offer, for a total equity value of $10,000. Assume that a bidder is willing to pay $5,000 above this market value for control of the target firm. Therefore, the bidder is willing to pay $15 per-share in an any-or-all offer. Let us further assume that there is a strong expectation that in the near future (say 50 days) another bidder will offer $18 per share through an any-or-all offer.

Despite the expectation of a higher offer in the near future, the first bidder can fashion a two-tier offer to pressure target shareholders into responding while still paying only a $5,000 premium. Specifically, the first bidder offers $20 per-share for 500 shares on a proration basis, and $10 per share for the other 500 shares, to be paid after the

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3/ Michael Bradley, "Interfirm Tender Offers and the Market for Corporate Control," Journal of Business, 1980, pp. 345-376. See especially pp. 355-356. The prisoner's dilemma is created by placing two suspected perpetrators of a crime in separate rooms and presenting each with the following proposition. If you confess and your partner does not, he receives the harshest punishment and you go free. If he confesses and you do not, then you receive the harshest punishment and he goes free. If both confess, then both receive moderate punishment. The rational prisoner will confess to avoid the harshest punishment, even though no confession results in both going free.

first offer is executed. The blended price is $15, which equals the outlay in an any-or-all offer of $15 per share.

Faced with this offer, each target shareholder will reason that: (i) if other shareholders tender, then I should tender to avoid receiving only $10 for my shares; (ii) if other shareholders hold, then I should tender to receive the first-tier price of $20 per-share, with little prorationing risk if the offer succeeds. This reasoning will lead rational shareholders to tender. The result holds even though all shareholders know that concerted, organized refusal to tender would be the best strategy since it would allow by assumption all to receive $18 per share in the near future from an alternative bidder. The prisoner's dilemma that is created by the two-tier offer causes the shareholders to accept the lower-valued offer having a $15 blended price.

We studied all control contests involving partial or two-tier offers in between 1981 and 1984 for evidence that any-or-all offers are disadvantaged relative to partial or two-tier offers in contests or that shareholders may be accepting a lower return by approving a partial or two-tier offer. As detailed in Section V, there is virtually no evidence to support the suggestion that two-tier or partial offers can defeat competing any-or-all offers while providing lower premiums to target shareholders.

3. Under SEC regulations in effect before December 15, 1982, a two-tier or partial tender offer forced shareholders

to commit to tender their shares earlier than they would under an any-or-all tender offer. This incentive resulted from the SEC's increase in the minimum offer period from 10 calendar days to 20 business days in 1979. At the same time, the minimum period for the proration pool remained at 10 calendar days. Therefore, while an any-or-all offer gave target shareholders 20 business days to make their tendering decisions, the partial or two-tier offer forced target shareholders to decide within 10 calendar days or forfeit their right to prorata acceptance of their tendered shares.

Earlier commitments by target shareholders may benefit the bidding firm because target shareholders have less time to consider alternatives or wait for additional offers. This advantage to bidders of prorated offers has been eliminated since December 15, 1982, when the SEC extended proration rights throughout the offering period. We measure a substantial reduction in the incidence of two-tier and partial tender offers relative to any-or-all offers following this rule change.

IV. Empirical Results

A. Frequency of Two-Tier and Partial Tender Offers

Table 1a presents a breakdown by year and type of 228 tender offers between January 1981 and December 1984. There are 159 any-or-all offers accounting for 70 percent of the total. There are 69 partial and two-tier offers accounting for the remaining 30 percent. The relative incidence of any-or-all offers has increased steadily over the four years, from 58 percent in 1981 to 80 percent of the total in 1984. The incidence of two-tier offers has fallen to nine percent of the total in 1984.

B. Frequency of Negotiated Tender Offers

Table 1b presents a breakdown by year and by whether or not the initiating offer is negotiated with target management and by whether the successful tender offer is negotiated. More than half of all initiating offers are negotiated at the start (as of their public announcement). The proportion of all tender offer contests that are initiated by negotiated offers has increased steadily from 43 percent of the total in 1981 to 63 percent in 1984. Ultimately, more than three-quarters of all successful tender offers are negotiated. The proportion of tender offers that are ultimately negotiated has also increased steadily from 68 percent of the total in 1981 to 87 percent of the total in 1984. Negotiation now appears to be the rule rather than the exception.

Table 1c presents a breakdown of the frequency of tender offers by their type as well as by whether or not they are negotiated. Offers are categorized by the type and agreement of both the initial offer of the contest and by the type and agreement of the offer that is ultimately made. Any-or-all offers are the most frequent type of initiating offers at 65 percent of the total and two-thirds (100 of 148) of these are negotiated. Of those offers that are ultimately any-or-all

(159 of 228), 83 percent are negotiated at the end. About half of all initiating two-tier offers (21 or 40) are negotiated from the start, and virtually all (35 of 38) of the offers that ultimately take the two-tier form are negotiated in the end. Pure-partial offers are the least likely to be negotiated. Few initial partial offers (7 of 40) and somewhat more final partial offers (12 of 31) are negotiated.

C. Size of Target Firms

Table 2 reports the average size of target firms by type of tender offer (ultimately made). Any-or-all offers are used generally for smaller target firms. Target firms of any-or-all offers average $231 million in total equity value, as measured using the pre-contest stock price times the fully diluted number of shares. In contrast, targets of two-tier offers average $631 million and targets of pure partial offers average $447 million.

Tables 3a and 3b provide more detailed information on the distribution of target size by type of offer. Table 3a shows the absolute and relative distribution of target size by type of offer. This table reveals that 81 percent of two-tier offers are for target firms of more than $50 million in equity value. On the other hand, only 47 percent of any-or-all offers and 48 percent of partial offers are for these larger firms.

Table 3b reports the percentage of each type of offer in each class of target size. As the size of the target firm increases, two-tier offers become increasingly prevalent and any-or-all offers play a lesser role. For target firms with less than $5 million in equity value, 90 percent of the 21 tender offers made are any-or-all offers and none are two-tier. For the very largest firms (more than $1 billion in equity value), only 38 percent of the 13 offers are any-or-all offers, while 47 percent are two-tier. Clearly, two-tier tender offers play an important role in takeover contests for large targets while any-or-all offers are used more for smaller targets.

D. Premiums in Tender Offers

1. Blended Premiums

Blended premiums for the three different types of tender offers are compared by year in Table 4a. The four-year averages show that the mean premium for any-or-all offers is highest at 59.6 percent, compared with a slightly lower premium of 54.5 percent for two-tier offers. Partial offers yield a much lower average premium of 20.1 percent.

A closer look at the distribution of blended premiums (Table 5) further reveals the similarity between the magnitude of any-or-all and two-tier premiums. For example, 71 percent of two-tier premiums are greater than 40 percent while 69 percent of the any-or-all offers exceed 40 percent premiums. Therefore, we do not find a substantial difference between any-or-all premiums and two-tier premiums.

Blended premiums for negotiated and non-negotiated tender offers are compared by year in Table 4b and by the three different types of tender offers in Table 4c. Premiums ultimately received by target shareholders are nearly as great (51.7 percent) when the initiating offer is negotiated as when it is not (55.5 percent). Below is a ranking from high to low of average blended premiums ultimately received, classified by type of initiating offer and whether the initiating offers was negotiatd.

non-negotiated any-or-all (67.5 percent)
negotiated two-tier (58.5 percent)
negotiated any-or-all (52.6 percent)
non-negotiated two-tier (51.9 percent)
non-negotiated partial (40.2 percent)
negotiated partial (18.2 percent).

On average, target shareholders fare best when the contest is initiated by a non-negotiated, any-or-all offer. They fare worst when the initiating offer is a negotiated, partial offer. In general, shareholders receive substantial premiums (averaging more than 50 percent) when the takeover contest begins or ends with either an any-or-all offer or a two-tier offer. This is true irrespective of whether or not the initiating offer or the successful offer is negotiated. In sum, these results show that, ignoring partial offers, there are no substantial differences in the average blended premiums ultimately received. It is important to note (as detailed below) that partial offers are generally made for less than a controlling (51 percent) interest.

2. Bid Premiums

The bid premium is the first-tier premium. As shown in

Table 6, the average bid premium is similar for any-or-all (59.6 percent) and two-tier offers at (62.8 percent). The pure partial bid premium is 32.2 percent. Referring back to blended premiums, it is clear that the blended premiums in two-tier and pure partial offers are less than their corresponding bid premiums. The generally lower second-tier price lowers the blended premium, especially for partial offers.

3. First-Tier and Second-Tier Premiums

Table 7 divides the blended premium of two-tier and pure partial offers into its components -- the first-tier and second-tier premiums. In every year the mean second-tier premium is positive for both two-tier and for pure partial offers, indicating that the market value of the second tier generally exceeds the pre-offer market price of the target. The average second-tier premium is 44.8 percent for two-tier offers and 12.0 percent for pure partial offers. These second-tier premiums are clearly substantial on average.

Table 8 reports data on the difference in magnitude between first-tier and second-tier prices (P_T relative to P_E). This computation addresses the concern that target shareholders are induced to tender to two-tier and partial offers because of large differences between the values of the two tiers. The per-share value of the first-tier (P_T) is 15.7 percent greater than the second-tier (P_E) for two-tier offers on average. For partial offers, the value of the first-tier price is 24.2 percent larger than the second-tier on average.

In two-tier offers, this difference between the value of the two tiers is not very large, especially when compared to the difference in pure partial offers.

Table 8 provides a detailed breakdown of the relative difference between the value of the two tiers in two-tier and pure-partial offers. The first-tier price exceeds the second-tier price by less than 20 percent for 71 percent of the two-tier offers. This is true for only 48 percent of the partial offers.

4. Fraction Tendered and Purchased

Table 9 presents an accounting of the disposition of the shares of tender offer targets. It shows the average percentage of outstanding shares (fully diluted) that are held by the bidder prior to the offer, or purchased privately (outside of the bid) from large holders. It also shows the percentage of shares that are tendered into the offer, and the percentage purchased in the tender offer. These data are from the bidder's final (amended) 14D filing with the Securities and Exchange Commission. Averages are reported for successful any-or-all, two-tier and partial offers, and by whether or not the offer is ultimately negotiated.

On average, any-or-all bidders purchase through the public offer 73 percent of the total outstanding shares. Combined with their average prior holding of 13 percent, any-or-all bidders acquire, on average, a total of 86 percent. Two-tier bidders purchase an average of 46 percent of outstanding shares through their public offers, giving a total holding of 50 percent when combined with their prior holdings of four percent. Note that two-tier offers provide bare majority control, on average, before the second tier. Pure-partial bidders purchase an average of 22 percent, which is insufficient to give them majority control even when combined with their average prior holdings of 14 percent. Generally, any-or-all and two-tier bids are for majority control while partial offers are not.

The average fraction tendering into any-or-all offers (73 percent) is higher than that into two-tier offers (62 percent) and higher than that into pure-partials (34 percent). For each type of offer, more shares are tendered, on average, into negotiated offers than into non-negotiated offers. Specifically, 76 percent tender into negotiated any-or-all offers compared with just 57 percent into non-negotiated any-or-all offers. Similarly, 63 percent tender into negotiated two-tier offers compared with an average of 50 percent tendering into non-negotiated two-tier offers. Finally, 50 percent tender into negotiated partial tender offers compared with 24 percent into non-negotiated partial offers.

These data on tendering contradict three important pieces of conventional wisdom. First, a surprisingly large fraction of equity holders forego the opportunity to participate in these lucrative tender offers. Without speculating about underlying motivations for this result, it is notable that, even for the high-response any-or-all offers, there remains untendered on average 14 percent of the outstanding shares.

The second surprising result is that the tendering response is actually less for the supposedly more coercive types of offers. In particular, the response is greatest for any-or-all offers and less for two-tier and partial offers. The tendering response runs directly counter to the coerciveness of the offer, as measured by the difference between tiers (shown in Table 7).

The third surprising result is that the tendering response for each type of offer is less for non-negotiated offers than it is for negotiated offers. This contradicts the popular notion that non-negotiated offers are more coercive than negotiated offers. Apparently, many stockholders heed target managements advice in determining whether to tender or hold.

V. Multiple Bidder Contests

Table 10 lists the outcomes of multiple-bidder contests for corporate control between 1981 and 1984 with a view toward the question of whether partial or two-tier offers have a tactical advantage over other kinds of offers. It includes all multiple-bidder contests in which shareholders chose between a partial or a two-tier offer involving pro-rationing and an any-or-all tender offer or a merger offer with no pro-rationing. This survey shows that during this time period no (non-negotiated) partial or two-tier tender offer beat any (unenjoined) any-or-all tender offer or merger proposal offering a higher premium.

Of the 18 head-to-head contests between two-tier/partial and any-or-all offers, five were won by two-tier or partial offers. Of these, three (Gulf Oil, HMW Industries and Interpace) were won with a higher blended premium than that available from the competing any-or-all offer. In a fourth case (Conoco), the higher valued any-or-all offer was enjoined by the Justice Department. The one case in which a two-tier offer beat a higher valued any-or-all offer is that of Enstar Corp. in 1984. Here, the success of the two-tier offer was at least partly attributable to certain agreements between the two-tier bidder and the target. The failed any-or-all offer was non-negotiated and conditional on the recision of these agreements.

VI. Conclusion

This study of 228 tender offers between 1981 and 1984 has several noteworthy results. In general, any-or-all offers are more frequent than partial and two-tier offers, with the former accounting for 159 of the total 228 offers, and the relative incidence of any-or-all offers is growing while the incidence of two-tier offers is diminishing. In addition, the incidence of any-or-all offers is higher among smaller targets, while two-tier offers predominate among moderate-sized and large targets. This empirical regularity may reflect an underlying economic difference between any-or-all and two-tier offers, with the latter types favored by bidders for relatively large targets. This implies that any regulatory disincentives currently under consideration to partial and two-tier offers may have more important effects for larger takeover targets than smaller targets.

The incidence of negotiated tender offers is increasing. Almost two-thirds of the successful offers commenced in calendar 1984 were negotiated with target management from the start or they were initiated by negotiated offers. Of these successful 1984 offers, 87 percent were negotiated with target management as of their expiration. Both these percentages for initial and ultimate offers have increased steadily throughout the 1981-1984 period. This suggests that the negotiating positions of target managers have steadily improved in recent years so that negotiated tender offers are now the rule rather than the exception.

We present detailed comparisons of uniform premiums in any-or-all offers with two-tier and partial offers. The average premium for the 159 any-or-all offers is highest at 59.6 percent relative to the pre-offer market price. The 38 two-tier offers yield an average blended premium of 54.5 percent, while the 30 pure partial offers yield 20.1 percent. Any-or-all premiums and two-tier blended premiums are very similar in magnitude -- 71 percent of two-tier premiums exceed 40 percent while 70 percent of any-or-all premiums do so.

The two-tier offer yields an average first-tier premium of 62.8 percent, virtually identical to the corresponding premium for any-or-all offers of 59.6 percent. The average second-tier premium of 44.8 percent for two-tier offers is less than the first-tier premium, but it is considerably larger than the "implicit" second-tier premium of 12.0 percent afforded by partial tender offers. Indeed, the average second-tier premium for two-tier offers (44.8 percent) exceeds the average blended premium for pure partial offers (20.1 percent). Therefore, two-tier offers are nearly as beneficial to target shareholders as any-or-all offers, and two-tier offers are significantly more beneficial than pure partial offers which have no second-tier purchases by the bidders.

The study also investigates the relative differences between first-tier and second-tier premiums for two-tier and partial tender offers. Nearly three-fourths of the 38 two-tier offers have less than a 20 percent difference between the first and second-tier values. In contrast, less than half of the 25 pure partial offers have less than a 20 percent difference between the first- and second-tier prices. Therefore, while the second tier of a two-tier offer generally provides a lower premium than does the first-tier, the difference in magnitude between the two values is not large, especially when compared to pure partial offers. The average first-tier price is 15.7 percent larger than the second-tier price for two-tier offers, while it is 24.2 percent larger than the implicit second-tier price in pure partial offers.

A higher proportion of outstanding shares are tendered into any-or-all offers (73 percent) than into two-tier offers (62 percent) or into pure-partial offers (34 percent). Since relatively more target shareholders are able to resist tendering into two-tier and partial tender offers than any-or-all offers, these results contradict claims that shareholders are "stampeded" into tendering into two-tier and partial offers due to their greater coerciveness. In addition, the greater fraction of shares tendered into negotiated tender offers compared to non-negotiated tender offers, suggests that target managements can and do influence the tendering decisions of their shareholders.

In view of these results, it probably would not be beneficial to adopt regulatory changes which would encourage the use of partial tender offers instead of two-tier offers. The second-tier premium in two-tier offers is on average three times as large as the implicit second-tier value in partial offers. Any substitution of partial offers for two-tier offers would deprive target shareholders of this greater return.

Also, these results suggest that it is problematic whether target shareholders would benefit from further regulatory inducements to use any-or-all instead of two-tier offers. First, such a switch increases the returns to target shareholders only modestly, since any-or-all premiums on average exceed the blended premiums for two-tier offers by a relatively small margin. Second, in view of this data it is likely that forcing the use of any-or-all offers will deter some takeovers, especially of larger targets. The losses to target shareholders from such foregone transactions, even if they are few, can outweigh the benefits of higher any-or-all premiums. Finally, the regulatory change of December 1982 appears to have substantially eliminated the advantage that two-tier offers had.

TABLE 1a

Number of Tender Offers[1], By Type: 1981-1984
(percents in parentheses)

Type of Offer[2]

Year	Any-or-All[3]	Two-Tier[4]	Pure Partial[5]	Total
1981	35 (58)	12 (20)	13 (22)	60 (100)
1982	32 (61)	14 (27)	6 (12)	52 (100)
1983	26 (76)	5 (15)	3 (9)	34 (100)
1984	66 (80)	7 (9)	9 (11)	82 (100)
TOTAL	159 (70)	38 (17)	31 (13)	228 (100)

Notes:

[1] The data in this and subsequent tables cover cash tender offers that were partially or fully successful in that bidders acquired some or all the shares sought through the offer.

[2] Type of offer is the final form after all amendments to the offer.

[3] Any-or-all offers are for all tendered shares, as long as minimum conditions are met.

[4] In two-tier offers, the offer for shares is in two steps. In an explicit two-tier offer, the bidding firm agrees at the time of the initial offer with target management to purchase the remaining shares following the execution of the first-tier partial offer. In implicit two-tier offers, a second tier is revealed shortly after the execution of the tender offer.

[5] Pure partial offers are for less than all shares. There is no clean-up merger or tender offer closely following the execution of the tender offer.

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 1b

Number of Negotiated Tender Offers: 1981-1984
(percents in parentheses)

Stage and Negotiation Results of Offer

Year	Initial Offer Negotiated	 Non Negotiated	Ultimate Offer Negotiated	 Non Negotiated	Total
1981	26 (43)	34 (57)	41 (68)	19 (32)	60 (100)
1982	28 (54)	24 (46)	39 (75)	13 (25)	52 (100)
1983	21 (62)	13 (38)	28 (82)	6 (18)	34 (100)
1984	52 (63)	30 (37)	71 (87)	11 (13)	82 (100)
TOTAL	127 (56)	101 (44)	179 (79)	49 (21)	228 (100)

Note:

A negotiated tender offer is defined as one made pursuant to, or in association with, a written agreement with target-firm management. The initial offer is the first offer made by any bidder, not necessarily the bidder making the ultimate offer.

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 1c

Number of Tender Offers, By Stage, Type and Negotiation Results
(percents in parentheses)

	Stage of Offer	
Type of Offer and Negotiation Results	Initial Offer	Ultimate Offer
Any-or-All Offers:		
Negotiated	100 (44)	133 (59)
Non-negotiated	48 (21)	26 (11)
Two-Tier Offers:		
Negotiated	21 (9)	35 (16)
Non-negotiated	19 (8)	3 (1)
Pure Partial Offers:		
Negotiated	7 (3)	12 (5)
Non-negotiated	33 (15)	19 (9)
Total	228 (100)	228 (100)

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 2

Average Size[1] of Targets, by Type of Tender Offer: 1981-1984 ($ millions)

	Type of Offer[2]			
Year	Any-or-All	Two-Tier	Pure Partial	Total
1981	$138	$996	$883	$471
1982	63	591	135	213
1983	142	154	201	149
1984	396	428	107	367
TOTAL	$231	$631	$447	$327

Notes:

[1] Size is measured as the market value of target's equity. It is computed as the number of fully diluted common shares multiplied by the pre-offer market price of those shares.

[2] Type of offer is the final form after all amendments to the offer.

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 3a

Number of Tender Offers, By Size and Type
(percents in parentheses)

Type of Offer[1]

Target Size ($ million)	Any-or-All	Two-Tier	Pure Partial	Total
Less than 5m	19 (12)	0 (0)	2 (6)	21 (9)
5m to 10m	11 (7)	1 (3)	5 (16)	17 (7)
10m to 50m	53 (32)	6 (16)	9 (30)	68 (30)
50m to 100m	21 (14)	3 (8)	3 (10)	27 (12)
100m to 500m	44 (28)	15 (39)	10 (32)	69 (30)
500m to 1,000m	6 (4)	7 (18)	0 (0)	13 (6)
Greater than 1,000m	5 (3)	6 (16)	2 (6)	13 (6)
TOTAL	159 (100)	38 (100)	31 (100)	228 (100)

Note:

[1] Type of offer is the final form after all amendments to the offer.

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 3b

Tender Offers Accounted for by Each Target Size and Type of Offer

	Type of Offer*			
Target Size ($ million)	Any-or-All	Two-Tier	Pure Partial	Total
Less than 5m	90%	0%	10%	100%
5m to 10m	65	6	29	100
10m to 50m	78	9	13	100
50m to 100m	78	11	11	100
100m to 500m	64	22	14	100
500m to 1,000m	46	54	0	100
Greater than 1,000m	38%	47%	15%	100%

Note:

*Type of offer is the final form after all amendments to the offer .

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 4a

Average Percent
Blended Premiums by Type of Offer: 1981-1984

	Type of Offer*			
Year	Any-or-All	Two-Tier	Pure Partial	Total
1981	67.9	54.9	15.0	53.9
1982	68.0	53.1	38.4	60.6
1983	60.4	75.8	27.4	59.7
1984	50.7	41.1	12.9	45.7
TOTAL	59.6	54.5	20.1	53.4

Note:

*Type of offer is the final form after all amendments to the offer.

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 4b

Average Percent Blended Premiums, by Stage and Negotiation Results of Tender Offers: 1981-1984

Stage and Negotiation Results of Offer

	Initial Offer		Ultimate Offer		
Year	Negotiated	Non Negotiated	Negotiated	Non Negotiated	Total
1981	54.8	53.1	59.8	41.1	53.9
1982	58.0	63.6	58.8	66.2	60.6
1983	57.9	62.6	60.2	57.8	59.7
1984	44.1	48.5	46.2	42.0	45.7
TOTAL	51.7	55.5	54.2	50.2	53.4

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 4c

Average Percent Blended Premiums (Ultimately Received) by Stage, Type and Negotiation Results of Tender Offers

Type of Offer and Negotiation Results	Stage of Offer	
	Initial Offer	Ultimate Offer
Any-or-All offers:		
Negotiated	52.6	57.3
Non-negotiated	67.5	71.5
Two-Tier Offers:		
Negotiated	58.5	54.6
Non-negotiated	51.9	52.8
Pure Partial Offers:		
Negotiated	18.2	20.6
Non-negotiated	40.2	19.3

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 5

Distribution of Blended Premiums
By Type of Tender Offer
(percents in parentheses)

	Type of Offer*			
Average Percent Premium	Any-or-All	Two-Tier	Pure Partial	Total
less than 0%	3 (2)	1 (3)	3 (10)	7 (3)
0 to 20%	15 (9)	5 (13)	13 (42)	33 (14)
20 to 40%	31 (19)	5 (13)	12 (39)	48 (21)
40 to 60%	46 (30)	15 (40)	2 (6)	63 (27)
60 to 80%	26 (16)	8 (21)	0 (0)	34 (14)
80 to 100%	18 (11)	2 (5)	1 (3)	21 (10)
Greater than 100%	20 (13)	2 (5)	0 (0)	22 (11)
TOTAL	159 (100)	38 (100)	31 (100)	228 (100)

Note:

*Type of offer is the final form after all amendments to the offer.

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 6

Average Percent Bid Premiums[1], by Type of Offer: 1981-1984

	Type of Offer[2]			
Year	Any-or-All	Two-Tier	Pure Partial	Total
1981	67.9	68.9	29.2	59.8
1982	68.0	58.8	50.4	63.5
1983	60.4	78.9	50.3	62.2
1984	49.9	49.1	25.8	47.2
TOTAL	59.6	62.8	34.4	56.5

Notes:

[1] The bid premium is the overall premium in any-or-all offers and the first-tier premium in two-tier and pure partial offers.

[2] Type of offer is the final form after all amendments to the offer.

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 7

Average Percent First- and Second-Tier Premiums in
Two-Tier and Pure Partial Offers: 1981-1984

	TWO-TIER			PURE PARTIAL		
Year	First Tier	Second Tier	Blended Premium	First Tier	Second Tier	Blended Premium
1981	68.9	41.5	54.9	29.2	11.9	15.0
1982	58.8	43.8	53.1	50.4	20.1	38.4
1983	78.9	72.7	75.8	50.3	10.8	27.4
1984	49.1	32.6	41.1	25.8	7.2	12.9
TOTAL	62.8	44.8	54.5	34.4	12.0	20.1

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 8

Distribution of Percent
Differences Between First- and Second-Tier Values,[1]
for Two-Tier and Partial Tender Offers
(percents in parentheses)

Percent of Difference between Tiers	Type of Offers[2] Two-Tier	Partial
Less than 0%	7 (18)	5 (17)
0 - 20%	20 (53)	9 (31)
20 - 40%	3 (8)	7 (24)
40 - 60%	6 (16)	4 (14)
60 - 80%	1 (3)	3 (10)
80 - 100%	1 (3)	0 (0)
Greater than 100%	0 (0)	1 (3)
TOTAL[3]	38 (100)	29 (100)

Notes:

[1] The percent difference in tier values equals:

$(P_T/P_E) - 1$

[2] Type of offer is the final form after all amendments to the offer.

[3] Data on several offers are not complete. Offers missing data on a tabulation's key variable are dropped resulting in this table showing fewer observations than other tables.

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 9

Disposition of Shares in Tender Offers

Percent of Fully Diluted Shares Outstanding

Type of Offer[1] and Negotiation Results	Prior Bidder Holdings[2]	Tendered	Tendered Shares Purchased	Final Bidder Holdings
Any-or-All Offers:				
Negotiated	12%	76%	76%	88%
Non-negotiated	18	57	57	75
Total	13	73	73	86
Two-Tier Offer:				
Negotiated	4	63	45	49
Non-negotiated	5	50	50	55
Total	4	52	46	50
Pure Partial Offers:				
Negotiated	18	50	32	50
Non-negotiated	12	24	17	29
Total	14%	34%	22%	36%

Notes:

[1] Type of offer is the final form after all amendments to the offer.

[2] Prior bidder holdings are comprised of shares held by the bidder prior to the bid and any shares privately purchased outside of the bid.

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

Table 10
Tender Offer
Auction Contests for Control
1981-1983

(1) Target	(2) No. of Bidders	(3) No. of Any-or-All Bidders	(4) Winner Was Any-or-All?	(5) Offer With Highest Value Won?	(6) Reason if (5) is "No"
Brookwood Health	2	2	Yes	Yes	
Brunswick	2	0	No	Yes	
Buffalo Forge	2	1	Yes	Yes	
Cities Service	3	0	No	No	July 28, 1982, FTC authorized the issuance of a preliminary injunction of Gulf acquisition. Gulf then abandoned its bid.
Conoco	4	1	No	No	In Nov. of 1981 the Justice Dept issued a preliminary injunction against a Mobil Corp. acquisition of Conoco.
Enstar	2	1	No	No	
Fisher Scientific Corp. a/	2	1	No	Yes	

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a/ This is nominally a contest. In April of 1981 a merger proposal was turned down by management. This offer was never made to shareholders. Then in July, when the first offer was long gone, a successful partial tender offer was launched by another firm. The partial offer won, however, it was clearly the better offer.

Table 10
(continued)

(1) Target	(2) No. of Bidders	(3) No. of Any-or-All Bidders	(4) Winner Was Any-or-All?	(5) Offer With Highest Value Won?	(6) Reason if (5) is "No"
General American Oil	3	1	Yes	Yes	
General Steel Industries b/	2	1	Yes	Yes	
Gray Drug Stores	2	1	Yes	Yes	
Gulf Oil	2	1	Yes	Yes	
HMW Industries	2	1	No	Yes	
Interpace	2	1	No	Yes	
Lightolier	2	0	No	Yes	
Manufacturers Bancorp	2	0	No	Yes	
Marathon	3	0	No	Yes	
Means Services Inc.	2	0	No	Yes	
National Mine Service	2	0	No	Yes	
Norton Simon	3	0	No	Yes	

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b/ This is another case where an any-or-all beats a partial. However, it should be pointed out that the partial bid ran into legal problems because of prior open market purchases.

Table 10
(continued)

(1) Target	(2) No. of Bidders	(3) No. of Any-or-All Bidders	(4) Winner Was Any-or-All?	(5) Offer With Highest Value Won?	(6) Reason if (5) is "No"
Pabst	4	0	No	Yes	
Property Investors of Colorado	2	1	Yes	Yes	
Richardson	2	1	Yes	Yes	
Standard Coosa Thatcher	2	1	Yes	Yes	
St. Joe Minerals	2	1	Yes	Yes	
Stokely Van Corp	3	1	Yes	Yes	
Sunbeam	2	0	No	Yes	
Texas Gas Resources	2	1	Yes	Yes	
Union Commerce	3	1	Yes	--c/	

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c/ In this case Central Bancorp had the highest per share price on its partial offer. However, it lost to Huntington Bankshares' any-or-all offer when the Federal Reserve blocked Central's bid. Since we don't know what Central Bancorp's second tier would have been, and since the offers were otherwise close, it is difficult to determine whether the best offer won.

Sample List

Successful Any & All Cash Tender Offers (1981-1984)

Adams Drug Co., Inc., by Pantry Pride, Inc. (1984)
Aegis Corp., by Minstar Inc. (1984)
Amalgamated Sugar Co., by National City Lines, Inc. (1982)
Amerace Corp., by Raceco (1984)
American Motor Inns, Inc., by Prime Motor Inns, Inc. (1984)
American Sterilizer Co., by Amsco Acquisition Co. (1984)
Americal Welding & Manufacturing Co., by Hoover Universal, Inc. (1982)
Anta Corp., by Manor Care, Inc. (1983)
Associated Coca-Cola Bottling Co., Inc., by Coca Cola Co. (1982)
Atlantic Oil Corp., by Stephens, Inc. (1983)
Avco Corp., by Textron, Inc. (1984)
Bache Group Inc., by Prudential Insurance Co. of America (1981)
Baker Bros., Inc., by Roth Corp. (1982)
Bangor Punta Corp., by Lear Sieglar, Inc. (1983)
Bassett-Walker, Inc., by VF Corp. (1984)
Beck/Arnley Corp., by Guest Keen & Nettlefolds, PLC (1984)
Bekins Co., by Minstar, Inc. (1983)
Belknap, Inc., by David A. Jones (1984)
Buffalo Forge Co., by Ampco-Pittsburgh Corp. (1981)
Burgess Industries, Inc., by Valley Industries, Inc. (1982)
Burns International Security Services, Inc., by Borg-Warner Corp. (1982)
CFS Continental, Inc., by A. E. Staley Mfg. Co. (1984)
CNB Financial Corp., by O.C.I. Bancshares (1984)
Camelot Industries Corp, by Buckbee-Mears Co. (1982)
Cannon Mills Co., by Pacific Holding Corp. (1982)
Caressa, Inc., by AEA Investors, Inc. (1984)
Carnation Co., by Nestle, S.A. (1984)
Carpenter Paper Co., by Alco Standard Corp. (1981)
Cenco, Inc., by Manor Care, Inc. (1981)
Cenvill Development Corp., by First American Bank & Trust of North Palm Beach (1984)
Children's World, Inc. by Grand Metropolitan, Ltd. (1983)
Clausing Corp., by Rexnord, Inc. (1984)
Compugraphic Corp., by Bayer AG (1981)
Connecticut General Mortgage & Realty Investments, by Prudential Insurance Co. of America (1981)
Contech, Inc., by Rexnord, Inc. (1982)
Conwed Corp., by Cardiff Equities Corp., an affiliate of Leucadia National Corp. (1984)
Core Laboratories, Inc., by Litton Industries, Inc. (1984)
Criton Corp., by Dyson-Kissner-Moran Corp. (1982)
DSI Corp., by Anacomp, Inc. (1982)
Danly Machine Corp., by Ogden Corp. (1981)
Datatab, Inc., by Data Probe, Inc. (1983)
Delhi International Oil Corp., by CSR Ltd. (1981)
Donaldson, Lufkin & Jenrette, Inc., by the Equitable Life Assurance Society of the U.S. (1984)

Successful Any & All Cash Tender Offers (1981-1984) (cont.)

Dorchester Gas Corp., by Damson Oil Corp. (1984)
Electro-Protective Corp. of America, by Hawley Group Ltd. (1981)
Energy Reserves Group, Inc., by The Broken Hill Proprietary Co., Ltd. (1984)
Erickson Corp, by Lull Eng. Corp. (1981)
Esmark, Inc., by Beatrice Foods Co. (1984)
Fabri-Tek, Inc., by CTS Corp. (1982)
Fairfield-Noble Corp., by Lloyd Williams, Inc. (1981)
Financial General Bankshares, Inc., by Credit & Commerce American N.V. (1982)
First Marine Banks, Inc., by Barnett Banks of Florida, Inc. (1981)
First National Lincoln Corp. by Omaha National Corp. (1983)
Flickinger (S.M.) Co., Inc., by Scrivner, Inc. (1984)
Florida Coast Banks, Inc., by Barnett Banks of Florida, Inc. (1984)
Flower Time, Inc., by General Host, Inc. (1984)
Formigli Corp., by High Industries, Inc. (1982)
Frank's Nursery & Crafts, Inc., by General Host Corp. (1983)
Garfinkel, Brooks Brothers, Miller & Rhoads, Inc., by Allied Stores Corp. (1981)
Gas Service Co., by Kansas Power & Light Co. (1983)
General Portland Inc., by Canada Cement Lafarge Ltd. (1981)
Getty Oil Co., by Texaco, Inc. (1984)
Giddings & Lewis, Inc., by Amca International Corp. (1982)
Gino's, Inc., by Marriott Corp. (1982)
Grand Central, Inc., by FMI Associates (1984)
Graniteville Co., by Southeastern Public Service Co. (1983)
Gray Drug Stores, Inc., by Sherwin-Williams Co. (1981)
Gulf Corp., by Standard Oil Co. of California (1984)
Hawkeye National Insurance Co., by Gan Vie, Cie Francaise D'Assurance sur la vie. (1981)
Higbee Co., by Industrial Equity (Pacific) Ltd. (1984)
Hobart Corp., by Dart & Kraft, Inc. (1981)
Impell Corp., by Combustion Engineering, Inc. (1984)
Intermountain Gas Industries, Inc., by IMG Holdings, Inc. (1984)
Itek Corp., by Litton Industries, Inc. (1983)
James (Fred S.) & Co., Inc., by Transamerica Corp. (1982)
Jamesbury Corp., by Combustion Engineering, Inc. (1984)
Jetero Corp., by Beeler-Sanders Inc. (1982)
Juniper Petroleum Corp., by Damson Oil Corp. (1982)
Kentucky-Tennessee Clay Co., by Ranchers Exploration & Development Corp. (1983)
King James Corporation, by Manor Care, Inc. (1984)
Lane Bryant, Inc., by Limited Stores, Inc. (1982)
Leader Healthcare Organization, Inc., by Cenco, Inc. (1981)
Lenox, Inc., by Brown-Forman Ltd. (1983)
Lightolier, Inc., by Bairnco Corp. (1981)
Love Petroleum Co., by U.S. Energy Search, Inc. (1981)
Ludlow Corp., by Tyco Laboratories, Inc. (1981)
Magma Power Co., by Natomas Co. (1981)
Malone & Hyde, Inc., by Pittco Acquisition Corp. (1984)
Marshall Field & Co., by B.A.T. Industries PLC. (1982)
Masonite Corp., by United States Gypsum Co. (1984)

Successful Any & All Cash Tender Offers (1981-1984) (cont.)

Means Services, Inc., by ARA Services (1982)
Medford Corp., The Amalgamated Sugar Co. (1984)
Mesa Royalty Trust, by Mesa Petroleum Co. (1984)
Michigan Sugar Co., by Savannah Foods & Industries, Inc. (1984)
Mid States Holding Co., by American Insurance Management Co., Inc. (1984)
Miller Bros. Industries, Inc., by Miller Bros. Holdings, Inc. (1984)
Miller-Wohl Co., Inc., by Petrie Stores Corp. (1984)
Mississippi Valley Gas Co., by Yazoo Investment Corp. (1984)
Monarch Tile Manufacturing Co., by Societe Chimigue Routiere S.A. (1981)
National Mobile Concrete Corp., by Chaucer Alliance, Inc. (1982)
National Savings Corp., by Western Preferred Corp. (1982)
New Mexico Financial Corp., by Delwin W. Morton & Charles J. Wilson (1983)
Northwest Energy Co., by Williams Companies (1983)
Northwestern Mutual Life Mortgage & Realty Investors, by Northwestern Mutual Life Insurance Co. (1982)
Norton Simon, Inc., by Esmark, Inc. (1983)
Pabst Brewing Co., by S&P Co., Inc. (1984)
Page Airways, Inc., by Guthrie Corp. Ltd. (1981)
Pargas, Inc., by Reliance Group Holdings, Inc. (1983)
Parson's Corp., by E.S.O.P. (1984)
Pay'N Save Corp., by The Trump Group, Ltd. (1984)
Peoples Drug Stores, Inc., by Imasco, Ltd. (1984)
Petrolane, Inc., by Texas Eastern Corp. (1984)
Prairie Producing Co., by Placer Development, Ltd. (1984)
Prentice-Hall, Inc., by Gulf & Western Industries, Inc. (1984)
Puritan Fashions Corp., by Calvin Klien (1983)
Qonaar Corp., by Kroehler Manufacturing Co. (1981)
Rampac, by Pan-American Properties, Inc. (1983)
Rand Capital Corp., by Crossbill Inc. (1982)
REDM Industries, Inc., by Pullman Transportation Co., Inc. (1984)
RSR Corp., by RSR Holding Corp. (1984)
Reliance Universal, Inc., by Tyler Corp. (1981)
Richardson Co., by Witco Chemical Corp. (1981)
Rio Grande Industries, Inc., by The Anschutz Corp. (1984)
Roper Industries, Inc., by Dexter Corp. (1981)
SCA Services, Inc., by Waste Management, Inc. and Grenstar Corp. (1984)
SSP Industries, by TransTechnology Corp. (1983)
Sav-a-Stop, Inc., by Consolidated Foods Corp. (1982)
Schrader (Abe) Corp., by Interco, Inc. (1984)
Security National Life Insurance Co. of Puerto Rico, by Puerto Rican-American Corp. (1984)
Sonoma Vineyards, by Renfield Corp. (1984)
Stecher-Traung-Schmidt Corp., by International Paper Co. (1983)
Stokely-Van Camp Inc., by Quaker Oats Co. (1983)
Strother Drug Co., by Alco Standard Corp. (1981)
Suburban Propane Gas Corp., by National Distillers & Chemical Corp. (1983)

Successful Any & All Cash Tender Offers (1981-1984) (cont.)

Super Dollar Stores, Inc., by Variety Wholesalers (1981)
Tano Corp., by Rexnord, Inc. (1984)
TFI Companies, Inc., (now Cardiff Equties) by Leucadia National Corp. (1982)
Technicolor, Inc., by MacAndrews & Forbes Group, Inc. (1982)
Telerent Leasing Corp., by Aviation Group, Inc. (1984)
Texas Gas Resources Corp., by CSX Corp. (1983)
Texasgulf, Inc., by Societe Nationale Elf Aquitaine (1981)
Torin Corp., by Clevepak Corp. (1982)
Treadway Companies, Inc., by Fair Lanes, Inc. (1981)
Tri-American Corp., by Scottish & York Holdings Ltd. (1981)
Tribune Oil Corp., by Sabine Corp. (1983)
Tymshare, Inc., by McDonnell Douglas Corp. (1984)
Union Electric Steel Corp., by Ampco-Pittsburg Corp. (1984)
Union Gas Systems, Inc., by Z. G. Transitory Corp. (1984)
United Realty Investors, Inc., by Butterfield Savings & Loan Association (1983)
United States Equity & Mortgage Trust, by Real Estate Investment Properties (1984)
United States Industries, Inc., by Hanson Trust, PLC (1984)
United States Sugar Corp. by E.S.O.P. (1983)
Volume Merchandise, Inc., by VM Acquisition Corp. (1984)
Vulcan, Inc., by Ampco-Pittsburg Corp. (1984)
Walter Realty Investors, Inc., by Seville Corp. (1981)
Western Gear Corp., by Bucyrus-Erie Co. (1981)

Successful Two-Tier Cash Tender Offers (1981-1984)

Belco Petroleum Corp., by Internorth, Inc. (1983)
Bendix Corp., by Martin Marietta Corp. (1982)
Breeze Corporations, Inc., by TransTechnology Corp. (1982)
Bunker Ramo Corp., by Allied Corp. (1981)
Chem-Nuclear Systems, Inc., by Waste Management, Inc. (1982)
Cities Service Co., by Occidental Petroleum Corp. (1982)
Coldwell, Banker & Co., by Sears, Roebuck & Co. (1981)
Conoco, Inc., by Du Pont (E.I.) De Nemours & Co. (1981)
Continental Airlines Corp., by Texas Air Corp. (1981)
Data Terminal Systems, Inc., by National Semi-Conductor, Inc. (1983)
Dean Witter Reynolds Organization, Inc., by Sears & Roebuck and Co. (1981)
El Paso Co., by Burlington Northern, Inc. (1982)
Electronic Modules Corp., by Rexnord Inc. (1984
Enstar Corp., by Allied Corp. and Ultramar, PLC (1984)
Fisher Scientific Co., by Allied Corp. (1981)
HMW Industries, Inc. by Clabir Corp. (1983)
Heublein, Inc., by Reynolds (R.J.) Industries, Inc. (1982)
Instrumentation Laboratory, Inc., by Allied Corp. (1983)
Interpace Corp., by Clevepak Corp. (1983)
Jewel Companies, Inc., by American Stores Corp. (1984)
Jonathan Logan, Inc., by United Merchants & Manufacturers, Inc. (1984)
Kent-Moore Corp., by Sealed Power Corp. (1981)
Mallinckrodt, Inc., by Avon Products, Inc. (1981)

Successful Two-Tier Cash Tender Offers (1981-1984) (cont.)

Manufacturers Bancorp, Inc., by Ameribanc, Inc. (1983)
Marathon Oil Co., by United States Steel Corp. (1981)
Martin Marietta Corp., by Bendix Corp. (1982)
Midlands Energy Co., by Freeport-McMoRan, Inc. (1984)
Milton Bradley Co., by Hasbro-Industries, Inc. (1984)
Narco Scientific, Inc., by Healthdyne, Inc. (1982)
Olympia Brewing Co., by Pabst Brewing Co. (1982)
Pabst Brewing Co., by G. Heileman Brewing Co. (1982)
St. Joe Minerals Corp., by Fluor Corp. (1981)
St. Regis Corp., by Champion International Corp. (1984)
Schlitz (Jos.) Brewing Co., by Stroh Brewing Co. (1982)
Sta-Rite Industries, Inc., by Wicor, Inc. (1982)
Sunbeam Corp., by Allegheny International, Inc. (1981)
Supron Energy Corp., by Allied Corp. (1982)
Thiokol Corp., by Morton-Norwich Products, Inc. (1982)
Wallace-Murray Corp., by Household International, Inc. (1981)

Successful Partial Cash Tender Offers (1981-1984)

Applied Solar Energy Corp., by Stauffer Chemical Co. (1984)
Brunswick Corp., by American Home Products Corp. (1982)
Cedar Point, Inc., by S. Pearson & Son, Ltd. (1981)
Chesapeake Life Insurance Co., by Lifeshares of Nebraska, Inc. (1981)
Chieftain Development Co., Ltd., by Alberta Energy Co. Ltd. (1982)
Conoco, Inc., by Dome Petroleum, Ltd. (1981)
Conoco, Inc., by Seagram Co. Ltd. (1981)
Dan River, Inc., by Ichan Capital Corp. (1982)
Faberge, Inc., by McGregor, Inc. (1984)
First Maryland Bancorp by Allied Irish Banks, Ltd. (1983)
Florida Commercial Banks, Inc., by Hugh Culverhouse (1984)
G.F. Business Equipment, Inc., (now GF Corp.) by Anderson Equity Investments (1982)
General Steel Industries, Inc., by Walco National Corp. (1981)
Hamilton Oil Corp., by AB Volvo (1984)
Harsco Corp., by Crane Co. (1981)
Life Investors, Inc., by AGO International B.V. (1981)
Mission Insurance Group, Inc., by American Financial Corp. (1984)
National Mine Service Co., by Anderson Strathclyde PLC (1983)
Opelika Manufacturing Corp., by Technical Equipment Leasing Corp. (1981)
Pier 1 Imports, Inc., by Fugua Industries, Inc. (1981)
Phone-Mate, Inc., by Asahi Corp. (1984)
Pogo Producing Co., by Sedco, Inc. (1983)
Property Investors of Colorado by DBP Partners (1981)
Real Estate Investment Trust of America by San Francisco Real Estate Investors (1982)
Salem Financial Corp., by Salem Capital Corp. (1983)
Southside Bancshares Corp., by E.S.O.P. (1984)
Speed-o-print Business Machines Corp., by Peter Nisselson, et al. (1984)
Terrydale Realty Trust by BCG Associates (1981)
USP Real Estate Investment Trust by Life Investors (1981)
USP Real Estate Investment Trust by Minneapolis Investors (1981)

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